Challenges and Opportunities in the Tunisian Private Equity Sector

By

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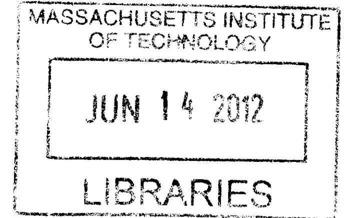

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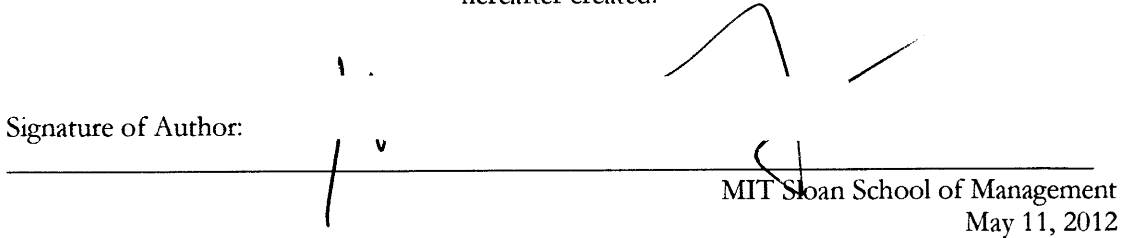

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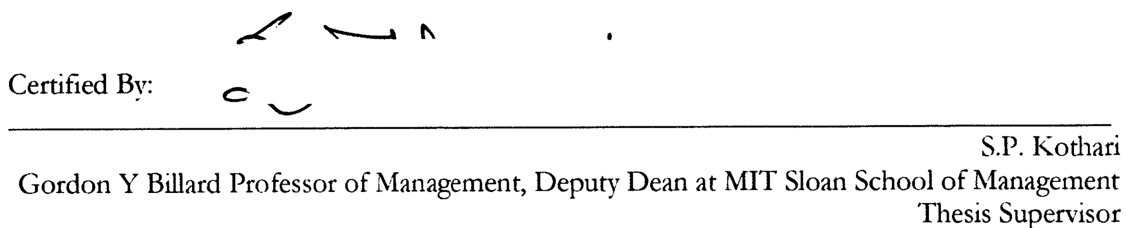

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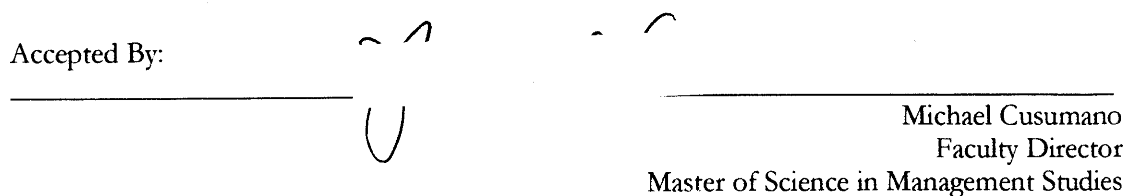

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Submitted to the MIT Sloan School of Management on May 11, 2012 in partial fulfillment of the requirements for the degree of Master of Science in Management Studies

Abstract

Most of the studies and research analyzing the private equity ("PE") sector in the Middle East North Africa ("MENA") region tend to focus more on the Middle East and less on North Africa. The case of Tunisia is probably the most appealing within the North African region regarding the transformational phase the industry is going through there. Accordingly, the main objective of this thesis will be to provide some keys to understand the dynamics of private equity in Tunisia.

The recent uprising has shown how ardently people are seeking a radical change in the current political and socio-economic model. Studying the private equity sector in Tunisia whilst balancing the underlying hurdles and opportunities, is certainly a first step towards understanding a complex but fundamental issue: how and to what extent can the promotion and the revitalization of investments in the country's private sector constitute a key lever for the government to meet the social claim for a sustainable development?

First of all, I believe it is essential to apprehend the backdrop of Tunisian private equity by analyzing global trends of the private equity industry, the rise of interest in emerging markets as well as the current macro environment in Tunisia. I will then examine the drivers and fundamentals of PE investment in Tunisia by analyzing the current framework in place and the specificities of the private equity lifecycle – from fundraising to exit. Finally, I will endeavor to investigate the hurdles various stakeholders might face as well as the opportunities they might enjoy, and I will ultimately highlight some of the options available to overcome obstacles and take advantage of favorable circumstances.

Thesis Supervisor: S.P. Kothari
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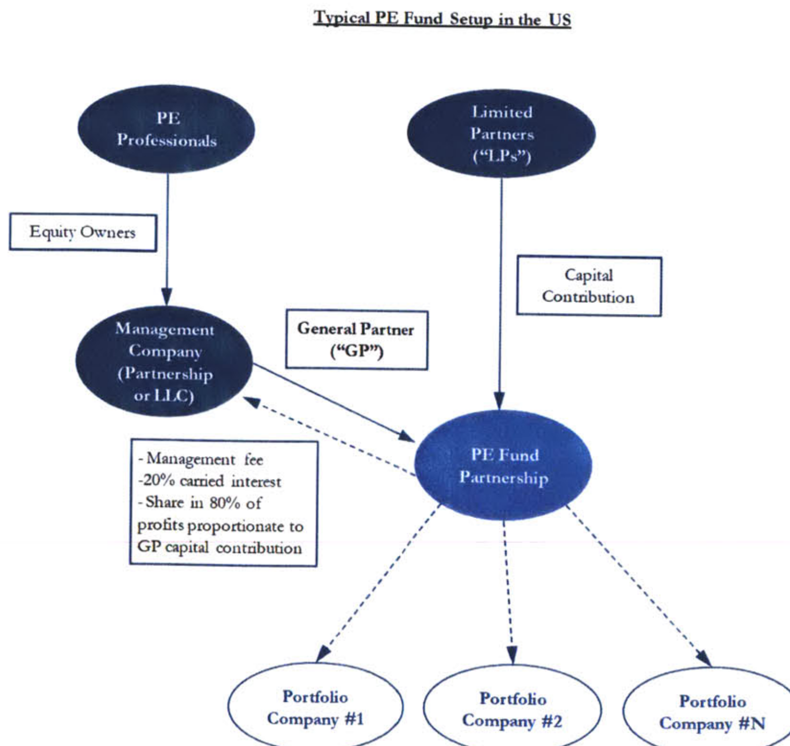
1. The Backdrop of Tunisian Private Equity

1) What is Private Equity?

Private equity ("PE") is the provision of equity capital by financial investors to private companies. The private equity community includes independent private equity and venture capital ("VC") funds as well as merchant banking subsidiaries of large institutions (investment banks, insurance companies, or even industrial companies).

As displayed in Figure 1.1, a team of private equity professionals typically sets up a fund partnership and raises money from a number of institutional investors. The management company owned by the PE professionals is the general partner ("GP") of the fund while the investors who provide the capital to invest are the limited partners ("LPs"). PE professionals typically invest the money raised from the LPs in private companies and split the share of profits with their investors upon liquidation of the fund. According to the industry standard, the GP usually charges a 2% management fee on the committed capital and a 20% carried interest on profits made. Once the capital is committed from LPs, PE professionals look for potential targets and call the capital as they source transactions (the investment period generally lasts 4 to 6 years). Portfolio companies are held for a period usually ranging from 4 to 7 years during which PE professionals seek to create value in order to reach an internal rate of return ("IRR") of 20-30% once they exit the company.

Figure 1.1:



There are several features that distinguish private equity investing from other types of passive investing[1].

- Private equity investment is an active type of investment by nature. Private equity professionals are typically actively involved in screening investment opportunities, negotiating and structuring deals once potential targets are identified, monitoring and guiding portfolio companies. They often hold one or several board seats and actively advise company on strategic and financial matters.

- Private equity investments have a limited lifetime. The contractual obligation for GPs to liquidate the fund after a certain number of years (usually 10 to 12 years). Therefore, private equity investments are not meant to be held indefinitely and all the funds coming from the sale of portfolio companies are distributed upon the liquidation of the PE fund.

- The securities purchased are generally privately held by a small group of investors (they are not publicly traded). Even in the rare cases whereby a PE fund invests in a publicly-held company, the securities purchased are non-public.

- Private equity investments often involve significant risk-taking. The fact that PE investors seek high returns is related to the significant level of risk involved in typical private equity investments. They intend indeed to deliver "geometric" returns rather than low-yielding returns provided for example by senior debt instruments. Financial instruments typically involved in PE transactions include common stock, convertible preferred stock or convertible subordinated debt (embedding a conversion feature into common stock), non-convertible preferred stock or non-convertible subordinated debt accompanied by "equity-kickers" (warrants), risky debt securities purchased at discount (usually in a turnaround deal).

- Private equity investors give a great importance to the quality of the management in portfolio companies. The skills and quality of people managing portfolio companies are seen as crucial to make high returns possible.

- Private equity investors seek a certain level of control. In case they do not purchase a controlling stake in the portfolio company, private equity investors typically seek to guarantee a certain level of control through contractual agreements and board representation.

- Private equity investments are expensive in terms of cost of capital in the sense that the equity-type returns sought by PE professionals need to be in line with the level of risk involved in their investments. Therefore, it is much more expensive for a company to raise private equity capital rather than traditional debt. In typical cases, the returns compensating PE investors not only factor in the idiosyncratic risk but also the illiquidity of the investment and the advisory services.

Experts commonly distinguish several types of private equity investment[1].

- Venture Capital: This type of investment targets companies at the early stage of their corporate cycle. Venture capital professionals typically invest along with entrepreneurs seeking to start a business. Such start-up transactions can be categorized into seed money investments (targeting potential businesses still requiring substantial research,

[1] Jack S. Levin, "Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions", 2010

development, or other important milestones before starting revenue-generating operations) and early-stage venture capital (financing start-up companies which are ready to begin or have recently begun revenue-generating activities).

- Growth Capital: Private equity professionals investing in the growth capital area target companies with a proven track-record (and most of the time already generating positive cash flows) but seeking capital to grow and expand their business activity (for example to develop a new product, build a new plant, expand distribution and market reach, start operations in a new country, acquire another company, etc.).

- Industry Consolidation: PE professionals can undertake a strategy of industry consolidation when they identify a fragmented market with a number of relatively small players and no market leader. In this case, they typically acquire one of the many players which will act as an industry platform for future roll-ups. Private equity investors then help the company buyout several players or start operations in markets where there is no desirable target business (or existing similar businesses) in order to create a national or regional leader.

- Leveraged Buyout: Private equity professionals operating in the leveraged buyout (or "LBO") field look for mature companies with very stable and visible cash flows. The rates of return generated exclusively by growth potential and operating efficiency usually do not meet private equity targets. In this area of private equity, investors often use financial engineering by levering up the company in order to take advantage of the leverage effect (as long as the return on assets is higher than the cost of debt, a high amount of debt can significantly increase the return on equity).

- Turnaround Investments: This type of investment involves the purchase of securities in a troubled company which is suffering losses, is over-leveraged, and/or is facing other financial and business setbacks. Turnaround investors may also purchase a portion of the troubled company's distressed debt (trading at a high discount) in order to obtain control of the company in case of bankruptcy or restructuring.

2) What are the Current Global Trends and Dynamics in the Industry?

A) Recovery in Private Equity Activity after the 2008-2009 Doldrums

The global financial and economic recession severely hit the private equity sector as deal activity, exits and fundraising faced a dramatic decline in 2008 and 2009, not to mention the sharp decrease and big balance sheet write-downs of portfolio companies due to an overall drop in valuation levels. Nevertheless, signs of recovery are clear now as activity picked up in 2010-2011.

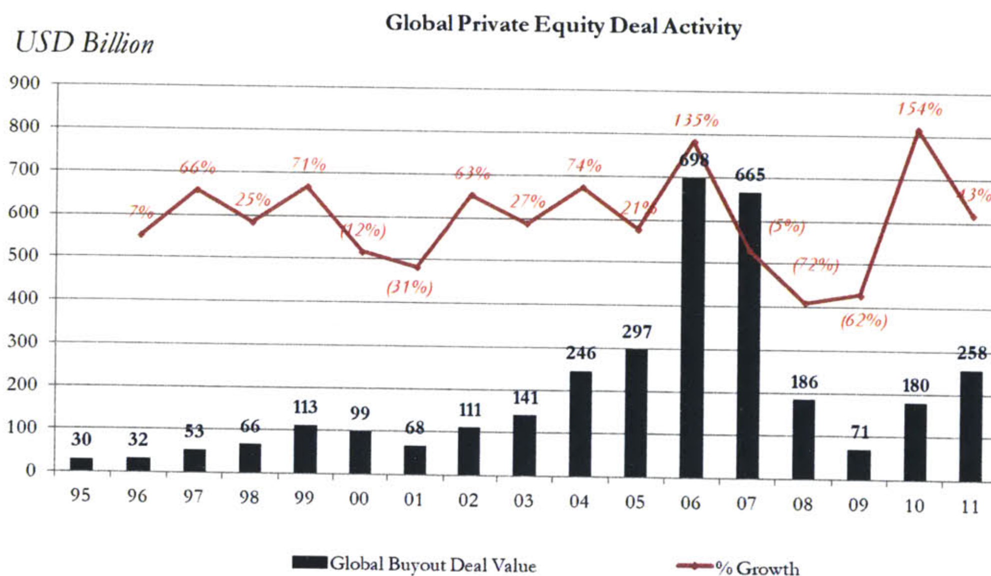
Global Private Equity Deal Activity

After five years of continued growth with a peak in 2006 at almost $700 billion (globally), private equity deal activity dramatically shrank under the effect of the financial and economic crisis. Before the crisis hit, the sector experienced a tremendous expansion mainly driven by cheap financing, strong economic growth, asset price escalation and institutional investors'

willingness to allocate a significant amount of funds for PE firms. The sharp reversal experienced by the credit market in the summer of 2007 entailed a strong rise in risk aversion and a dry-up of loan securitization, in particular collateralized loan obligations or "CLOs" on which large buyout firms were dependent to finance leveraged transactions. This important change in the credit market directly affected the ability if private equity firms to borrow under favorable conditions and consequently their capacity to generate deals. The climate of economic uncertainty and poorer performance of portfolio companies has made PE professionals more doubtful about investment opportunities and focus more on restructuring their existing investments.

However, overall deal activity started picking up again at the end of 2009. With a CAGR of +91% over 2010-2011, private equity-backed M&A transactions increased from $71 billion in 2009 (lowest level since 2001) to $258 billion in 2011 (in line with volume levels in 2004-2005) along with the global economic recovery (Figure 1.1).

Figure 1.1



Source: Bain Global Private Equity Report 2011, Preqin Research Report "2011 Private Equity Deals and Exits"

Private equity experts agree that the current trends in private equity deal activity is driven by the factors listed below.

- **A huge and aging "dry powder"**

At the end of 2009, private equity firms had approximately $1 trillion of dry powder – the amount of capital committed by LPs to private equity funds but remaining uncalled –, half of which for buyouts (other categories mainly include real estate, venture capital, distressed PE, mezzanine)[2]. More importantly, the dry powder for many of the PE firms is aging: capital needs to be urgently put to work. As PE funds have typically an investment period of 4 to 6 years and very high amounts of capital were raised between 2005 and mid-2008 (Figure 1.2), GPs are under pressure to invest before the investment period expires; otherwise, they would end up losing management fees associated to invested capital and loose somehow their "credibility".

[2] Preqin research reports

- **Valuation levels higher than expected**

This pressure on GPs to invest is important to understand why the deal activity picked up as soon as the economic environment showed some signs of improvement. However, one of the perverse effects of this ticking clock is that valuations surprisingly came back to high levels. According to Bain & Company[3], strong competition made acquisitions pricey and drove valuation levels almost up to the levels seen before the crisis (in 2010, on average 8.5x EBITDA in the US and 9.2x EBITDA in Europe). Most GPs were expecting to pay between 5.0x and 7.0x EBITDA[2]. Wary of overpaying, some of them preferred financing and supporting their portfolio companies rather than purchasing new assets and underestimating downside risks. Therefore, one might reasonably induce that the rebound in PE deal activity could have been even stronger if prices were more in line with downside risks related to the uncertainty hanging on global economic conditions.

- **A renewed but still fragile credit market**

Leveraged loans suffered from the crisis and decreased from over $700 billion freshly issued in 2007 to slightly over $100 billion in 2009[4]. Moreover, the fact that CDOs almost disappeared (from $1 trillion in 2006-2007 to barely $3 billion in the first semester of 2011[5]) is a key element to understand the current trend in private equity deal financing.

However, the appetite of credit markets for high-yielding assets significantly increased as the general level of interest rates is low (due to the expansionary monetary policy undertaken by central banks). Approximately $100 billion[3] of fresh leveraged loans were issued in 2010 versus $150 billion only in the first semester of 2011. "Covenant-lite loans" which are popular with companies owned by private equity firms because of less stringent conditions on the borrowing company, are now back on the market after 3 years during which almost no "cov-lites" were sold. The risk appetite of banks for those high-yielding products faces a structural challenge though: as the regulatory framework is moving towards more prudence regarding banks' balance sheets, banks are likely to ask for higher returns and drive spreads up in order to make their new model consistent. The "pickiness" of banks, the collapse of securitization and the availability of cash among bond investors have significantly increased the recourse to high-yield bonds. Those securities represented 25% of leveraged financing in 2010 and 28% in 2011 whereas their share was barely above 0% before. The volatility in capital markets makes it periodically difficult for PE firms to use high yield bonds to finance acquisitions; however, bridge financing is currently flexible enough to allow an opportunistic access to the market.

The renewed access to financing is an important driver of the current PE deal activity. The overall system has become "healthier" and more risk averse than it used to be before the crisis (Table 1.1).

---

[3] Bain, "Global Private Equity Report", 2011
[4] S&P LCD, 2011
[5] SIFMA, 2011

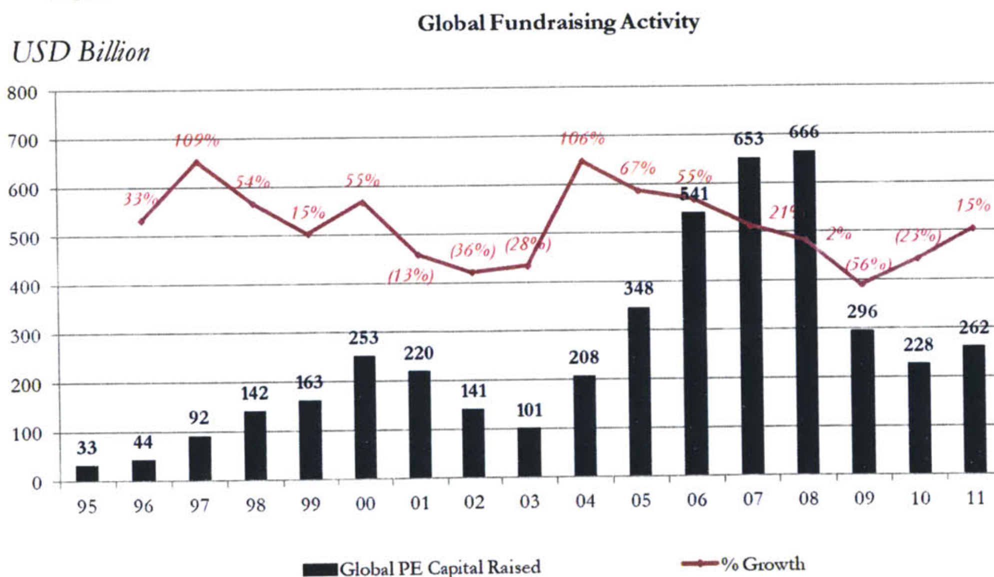
Table 1.1[6]

	Q2 2007	2011/2012
Leverage	7.0x	4.0x-5.0x
Structure	Senior, Second lien, PIK	Senior / Mezzanine or High yield bond
Minimum Equity Contribution	20%	30-45%
Repayment	All bullet	Partly amortized, partly bullet
Pricing	Senior: Libor + 2.25% Second Lien: Libor + 4.0% PIK: Libor + 9.0%	Senior: Libor + 5.0-6.0% Mezzanine / High yield: Libor + 10.0-12.0%
Covenants	Leverage only	Leverage, interest rate coverage, cash-flow cover, capital expenditure
Syndication	Up to 100% underwriter	More than one bank (or club syndicate for smaller deals)

Global Trends in Fundraising

The fundraising activity of private equity firms also steeply declined over 2007-2009 and continued to decline in 2010 (capital raised divided by 3 over the three-year period) while it increased only by 15% in 2011 (Figure 1.2).

Figure 1.2



Source: Bain Global Private Equity Report 2011, Preqin Research Report "2011 Private Equity Fundraising"

As previously developed, private equity funds wield a huge amount of dry powder (slightly under $1 trillion in 2010) due to the high level of fundraising activity pre-crisis. However, GPs

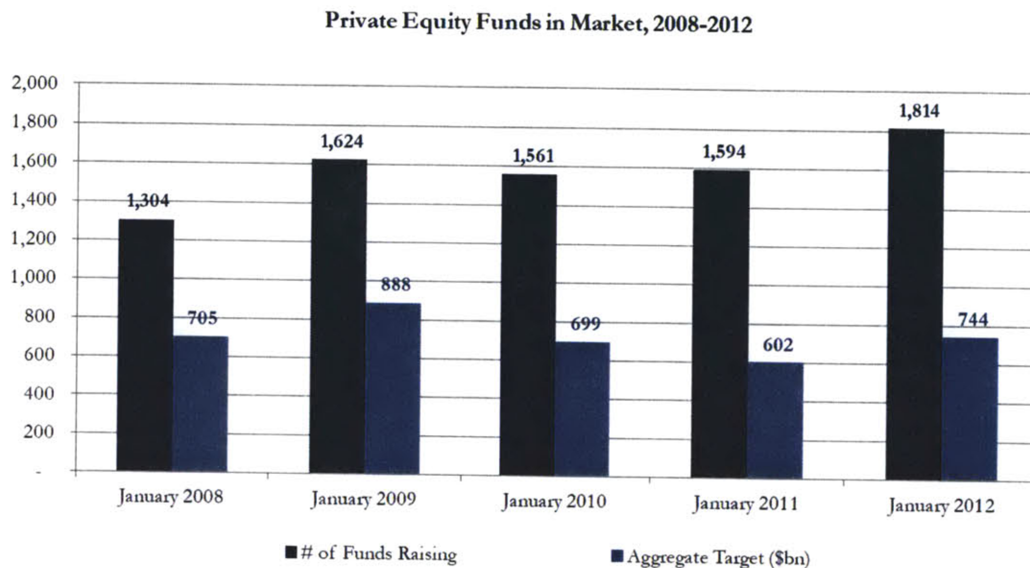
[6] Indicative information provided by a professional during a presentation at the Alternative Investment Conference at LSE in January 2012

are currently having difficulties to raise fresh money from LPs (half of PE funds which closed in 2010 and 35% in 2011 have not managed to raise their target amount[7]). Several factors justify the tightness of the fundraising market.

- **Overcrowd in GPs seeking to raise funds**

The imbalance between LPs' liquidity shortage and the volume of funds sought by GPs partly explains why a significant number of GPs were not able to raise their target amount. According to a study conducted by Preqin, there are currently 1,814 funds on the road seeking to raise an aggregate value of $744 billion whereas only $262 billion were raised in 2011.

Figure 1.3



Source: Preqin, 2012

- **Negative impact of dry powder**

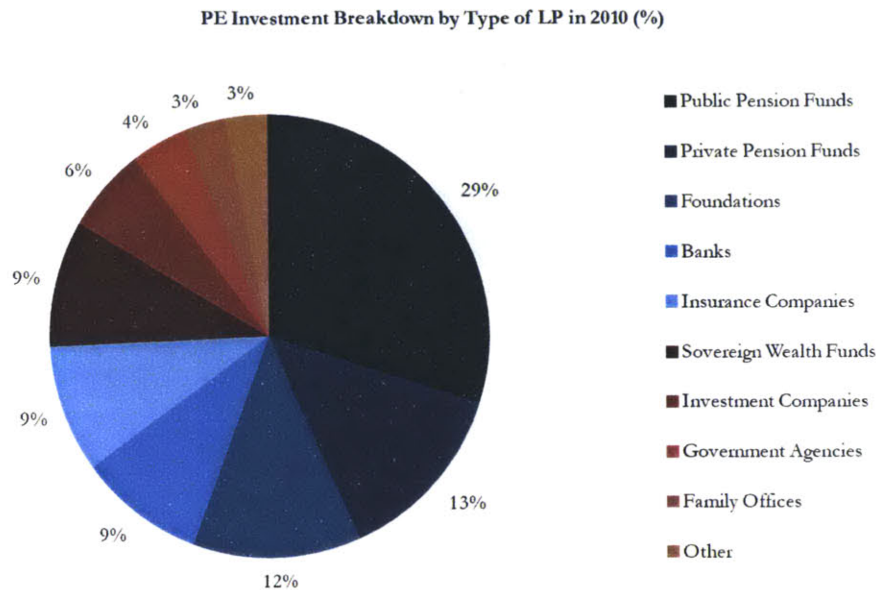
The large amount of uncalled capital and the currently high valuation levels raise doubts about opportunities for private equity investments. The c. $1 trillion of capital commitments also represents a huge overhang for LPs as they will have the contractual obligation to supply GPs with liquidity once capital calls are triggered.

- **Capital allocation impacted by the valuation of other asset classes ("denominator effect")**

As displayed in Figure 1.4, most of private equity capital is committed by institutional investors.

[7] Preqin, 2011

Figure 1.4



Source: Preqin, 2011

Institutional investors usually allocate their investments in private equity as a proportion of their total assets under management (pension funds, which account for 42% of capital committed to PE funds in 2010, allocate for instance on average 6-7% of their assets under management to private equity[8]). Consequently, as the overall valuation of the assets was hit by the crisis, the absolute amount allocated to private equity investments also shrank. The fact that institutional investors are reluctant to overweight an asset class in their portfolio dramatically reduces the room for more commitments to private equity GPs.

- **Mismatch between calls and distributions**

Although PE exits recently picked up, a study conducted by Bain & Company[3] shows that capital calls have surpassed capital distributions since 2007. It is indeed common during the lifecycle of a private equity fund (that is to say before its liquidation) that GPs distribute part of the capital to LPs as they exit some of their investments. The fact that capital calls currently outpace distributions increases the liquidity pressure on LPs.

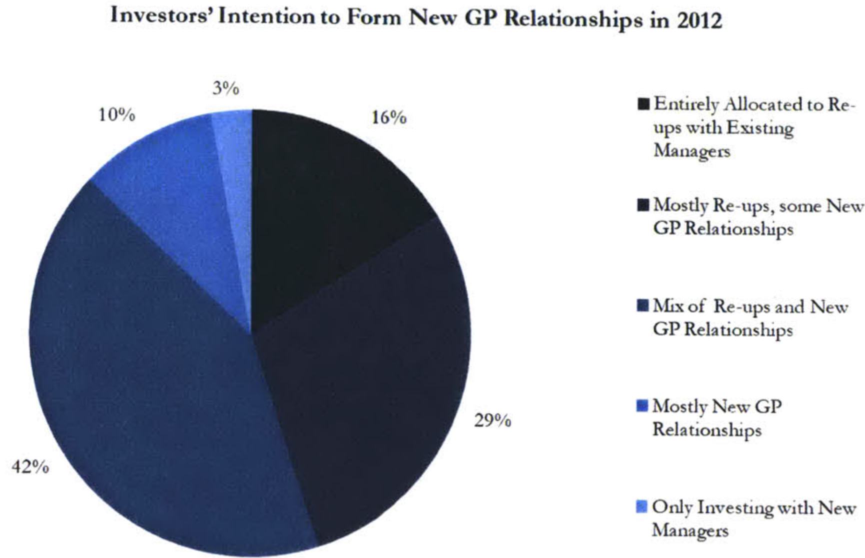
- **GP-LP relationship toughened up**

The rate of re-ups by GPs has decreased since 2007, which reflects the fact that LPs are seeking to invest with top quartile funds and are now favoring quality over quantity. The increased "pickiness" about proven track record, the more intense and exhaustive due diligence required, and finally the tougher negotiations on the compensation and the terms of partnerships, exacerbate the difficulty GPs are facing to raise funds.

According to a survey conducted by Preqin, fundraising is even more difficult for first-time GPs as almost 40% of interviewed LPs closed their doors to first-time funds. The mix of new GP relationships expected in 2012 is shown in Figure 1.5.

[8] Deutsch Bank Research Report, "Private Equity, Opportunities in Turbulent Times", October 12, 2011

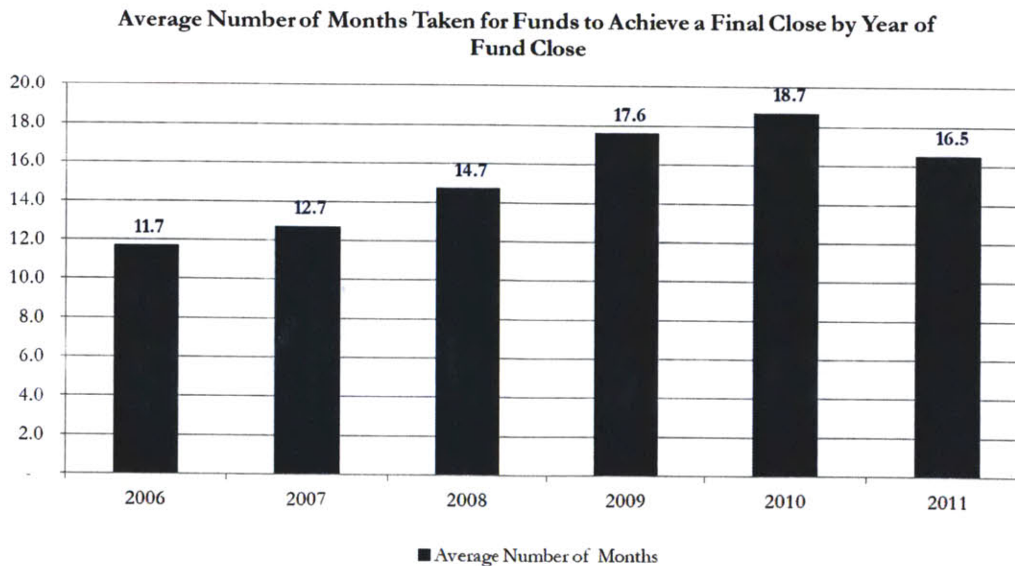
Figure 1.5



Source: Preqin, 2012

Another indicator of LPs' "pickiness" in committing capital post-2008 is the increase in the average time taken for funds to close (Figure 1.6). While it took on average one year for fund managers to close a fund in 2007, they needed on average more than a year and a half to do so in 2010.

Figure 1.6

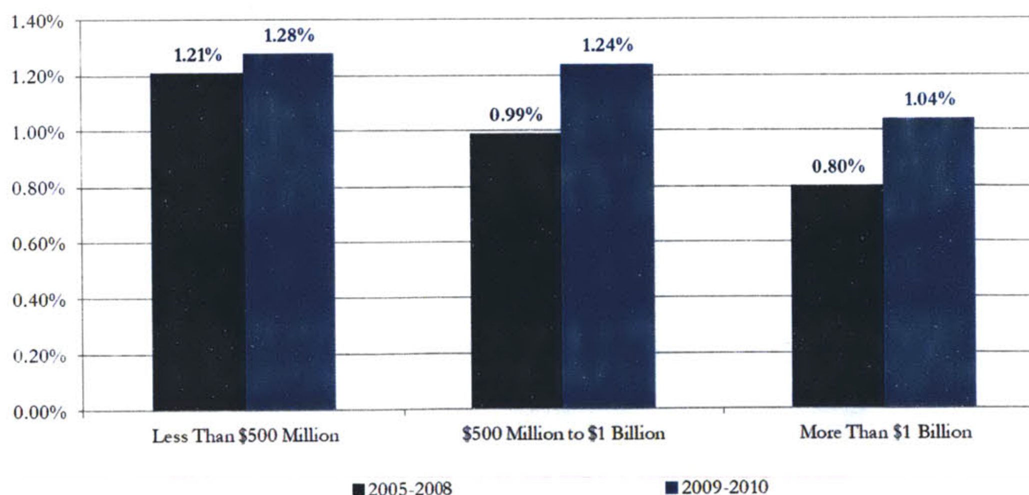


Source: Preqin, 2012

According to an article posted in "Private Equity Manager"[9], there is a growing tension between GPs and LPs over terms in funds' formation, more especially about fee structure. Quoting the journalist, "as the world crawled out of economic malaise and back into investment mode, LPs made clear they would no longer accept uniform charges across funds of varying performance". Typically, the compensation of GPs follows the "2-20" rule: funds' managers receive 2% of committed capital ("management" fee) and 20% share of the upside ("performance" fee). Such structure can entail a misalignment of interests because of the significant amount management fees represent (GPs would be less incentivized to deliver high performance returns). A research conducted by Oliver Gottschalg and Bernd Kreuter shows that GPs earn on average more than three times in management fees than in carried interest. This element combined to the current slowdown in PE activity explains why LPs have become more sensitive to fee structure. According to Bernd Kreuter, head of alternatives at Feri Institutional Advisors, "there is a risk a GP will be more concerned about their ability to raise a next fund instead of maximizing returns for their current investors". As a matter of fact, one of the most preeminent institutional investors, the California Public Employees' Retirement System ("Calpers"), won fee concessions from CIM Group and Apollo Management of $175 million in 2011[9]. Therefore, LPs now tend to toughen their due diligence of fund managers. According to Bela Schwartz, CFO of The Riverside Company, "more LPs are asking for a firm's budget or projection of future operational expenses".

Fees charged to portfolio companies are another way for PE firms to generate revenues. Those fees are mainly composed of "deal" fees (charged to portfolio companies post-transaction) and "monitoring" fees (paid by portfolio companies to PE owners for their advisory services). A study conducted by Preqin and Dechert LLP shows that such fees significantly increased in 2009 and 2010 (Figures 1.7 and 1.8). One could reasonably assume that the increased tension with LPs over compensation has pushed GPs to increase fees charged to their portfolio companies.

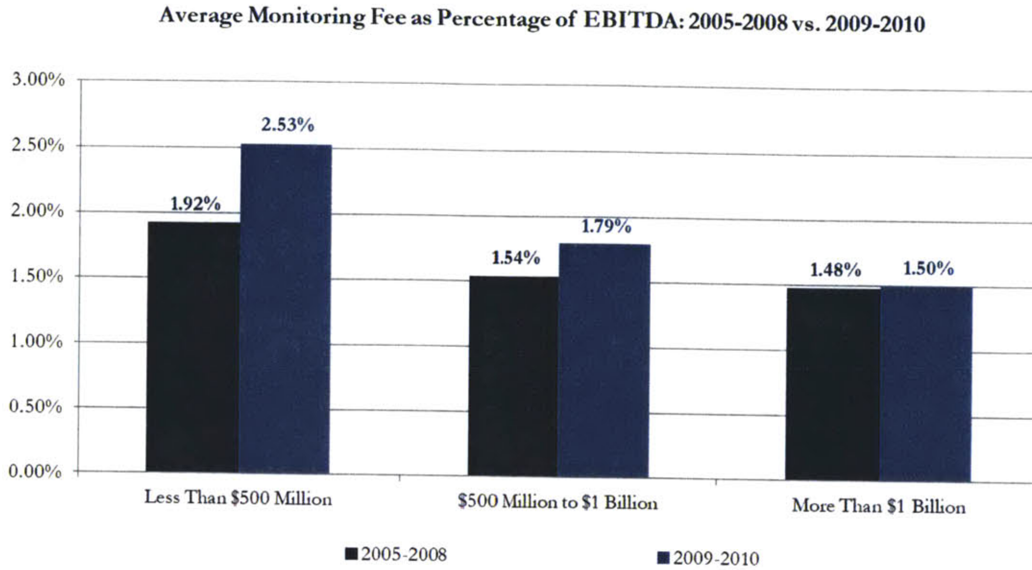
Figure 1.7



Source: Preqin & Dechert LLP, 2012

[9] http://www.privateequitymanager.com, Nicholas Donato, "Fees Trump Carry in GP Compensation", 20-July-2011

Figure 1.8

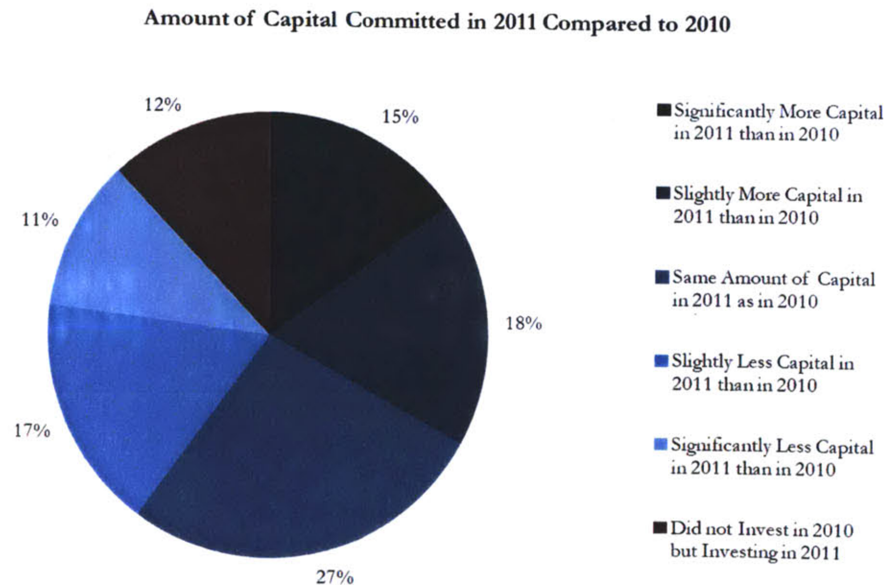


Source: Preqin & Dechert LLP, 2012

- **More optimism among LPs**

As the activity is recovering, there is currently an overall sentiment of optimism among investors regarding their commitments in private equity investments. As shown in a survey conducted by Preqin (Figure 1.9), only 40% of the investors interviewed expected to commit less capital in 2011 than in 2010.

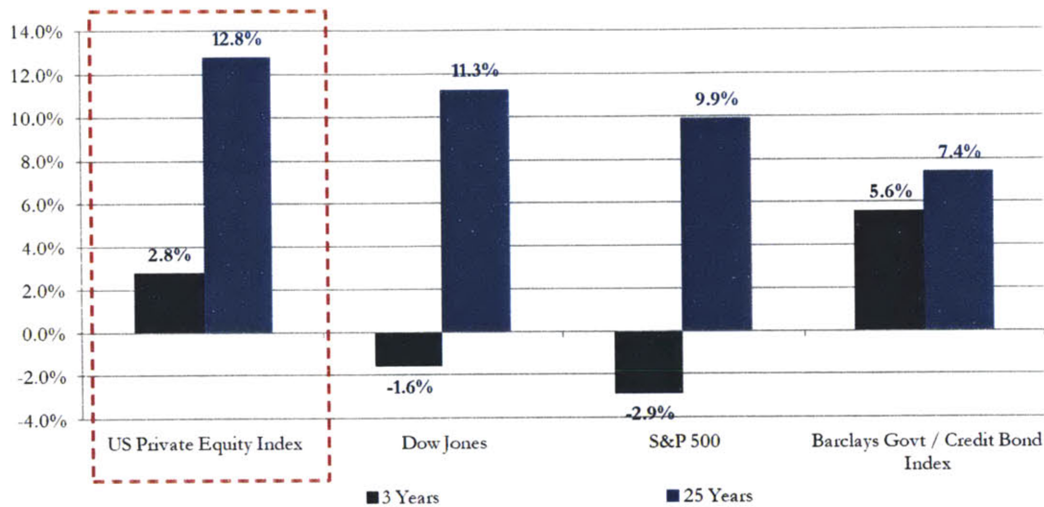
Figure 1.9



Source: Preqin, 2012

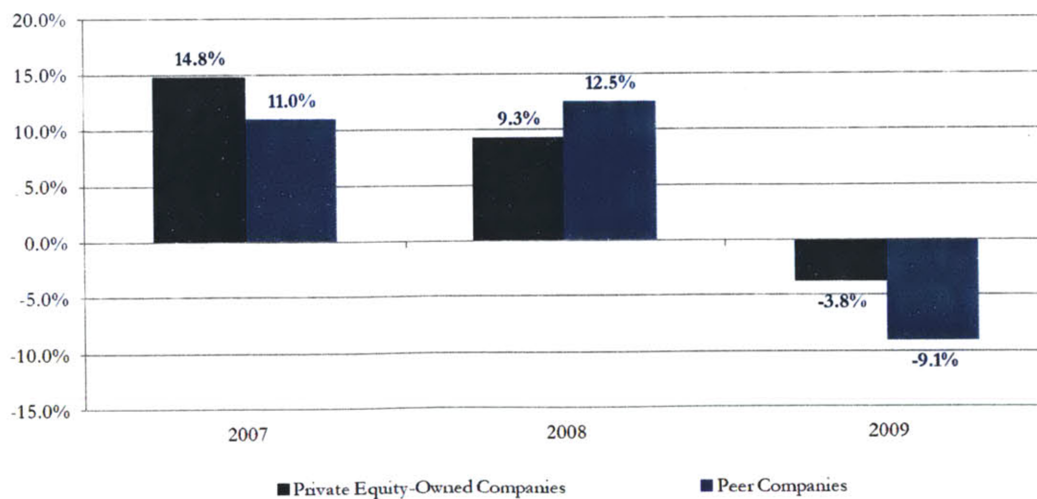
Moreover, private equity as an asset class has historically delivered higher returns than the equity and bond markets (Figure 1.10). The industry performed relatively well throughout the financial and economic crisis. The higher performance of private equity investments is underpinned by a study conducted by A.T. Kearney in 2011 showing that private equity-owned firms provide a better top-line performance and turned to be more resilient to the crisis in 2009 (Figure 1.11).

Figure 1.10



Source: Cambridge Associates, 2011

Figure 1.11

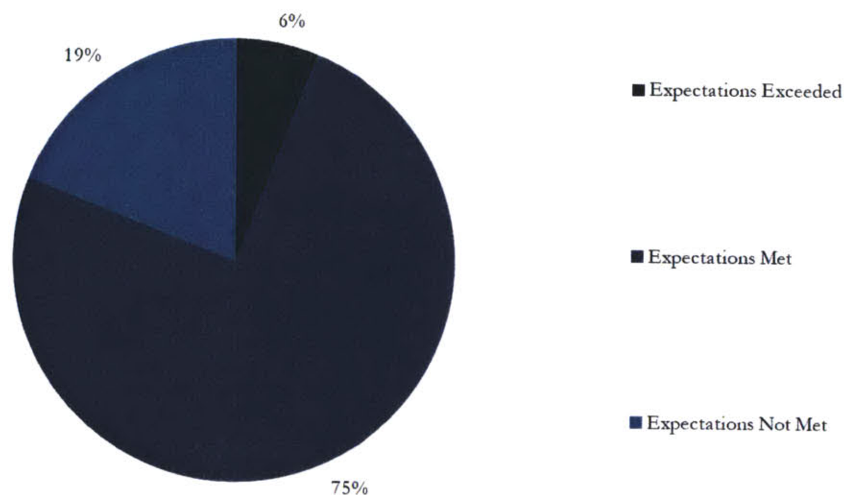


**Based on 109 private equity-owned firms in Germany, Austria and Switzerland and a peer group of 309 companies*

Source: A.T. Kearney Report, 2011

The attractive "alpha" delivered by the industry translates into a high "satisfaction rate" among LPs (Figure 1.11). According to a study conducted by Preqin, 63% of investors expect their private equity returns to be 400 basis points higher than returns in public markets, and a quarter of them expect a positive difference of 200-400 basis points. This element constitutes a positive sign regarding future fundraising activity. However, the overall attractive performance should not hide the difference between top-tier and less performing PE funds and the fact that LPs are expected to be choosier in their future private equity commitments.

Figure 1.12

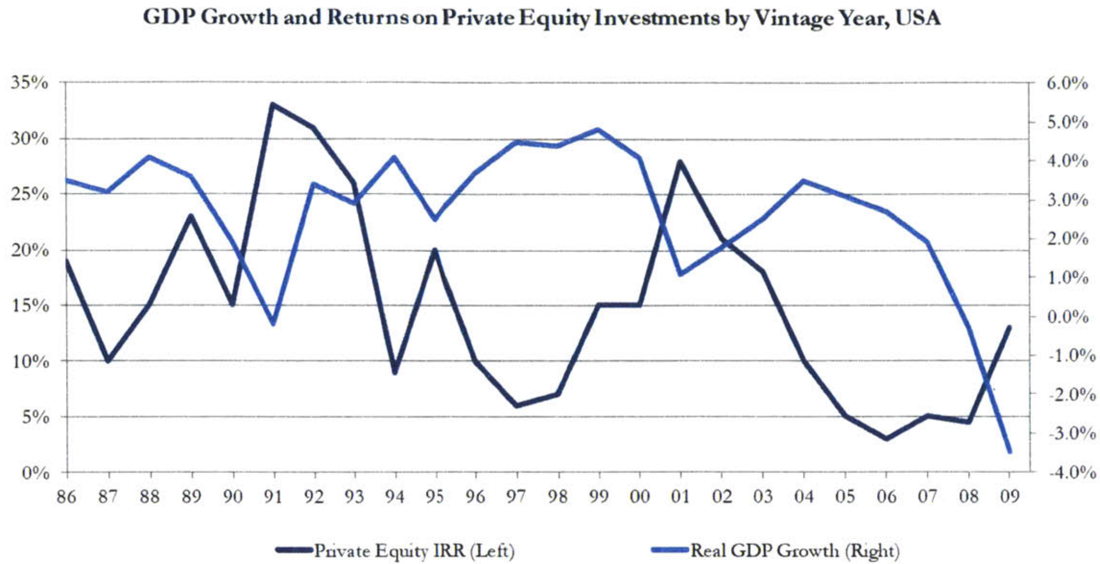


Source: Preqin, 2012

Although there is a cyclical trend in rates of return delivered by private equity funds (crises have an adverse impact on returns whereas macroeconomic growth entails high positive returns), returns generated by vintage year (the year in which the fund is launched), which constitutes a better indicator to LPs, have proved to be counter-cyclical over time (Figure 1.13)[10]. More precisely, in a period of economic downturn, private equity investments generate higher returns. This might be due to more scrutiny in investments and lower asset prices. According to Deutsche Bank, this anti-cyclical correlation is even truer for top-quartile funds. Even though the overhanging dry powder drives valuation levels up, the current gloomy economic prospects could paradoxically generate higher returns by vintage year in the future.

[10] Deutsch Bank Research Report, "Private Equity, Opportunities in Turbulent Times", 12-October-2011

Figure 1.13



Source: Deutsche Bank Report, Bureau of Economic Analysis

B) Shift towards Emerging Markets

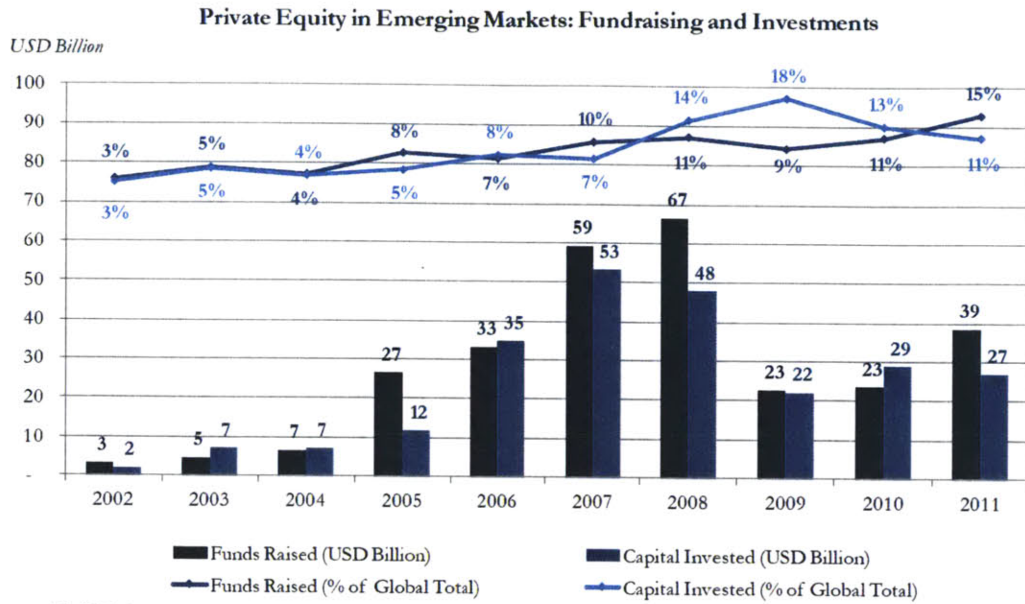
Rise of Interest in Emerging Markets

As shown in Figure 1.14, private equity activity in emerging markets ("EM") has strongly increased since 2004 in terms of funds raised and capital invested:

- Funds raised grew from $7 billion in 2004 to $39 billion in 2011 with three major trends: a sharp increase from 2004 to 2008 with a peak in 2008 at $67 billion, a strong decrease in 2009-2010 at $23 billion for both years, and finally a significant recovery in 2011 with total funds raised standing at $39 billion. In terms of percentage of global fundraising, 2011 was historically the strongest year with funds raised targeting emerging markets peaking at 15% of global funds raised. This element shows the stronger investors' appetite for private equity investments in emerging markets.

- Private equity capital invested in emerging markets also significantly grew between 2004 and 2008 from $7 billion to $48 billion with a peak in 2007 at $53 billion. Despite the sharp decrease in 2009 to $22 billion, capital invested in emerging markets as a percentage of global private equity investments in 2009 was at a historical peak. This fact reflects the resilience of emerging markets to the global financial and economic crisis as well as the availability of investment opportunities in such markets.

Figure 1.14

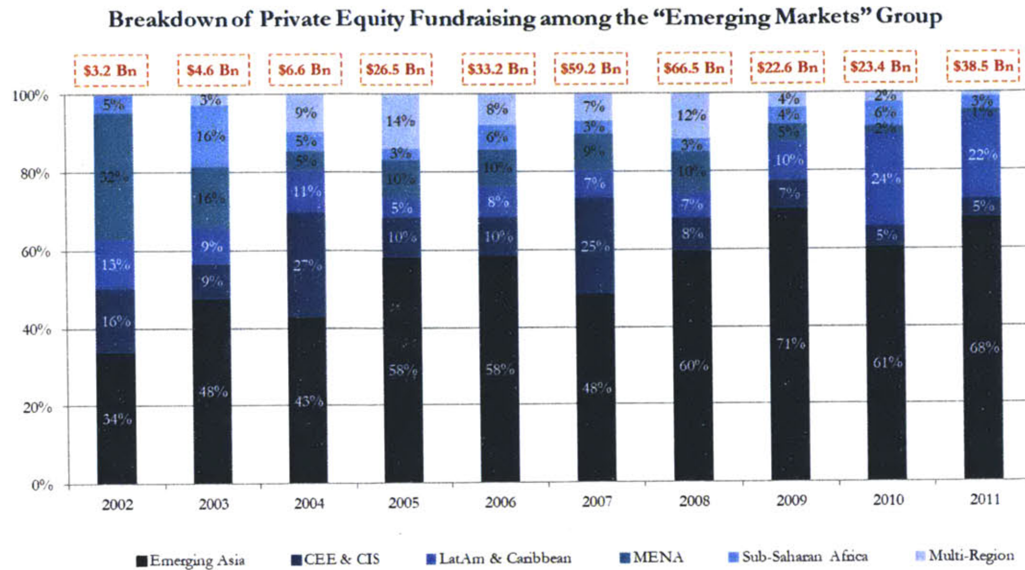


Source: EMPEA

Different Trends among the "Emerging Markets" Group

As indicated by Figure 1.15, private equity fundraising targeting emerging markets was primarily captured by (emerging) Asian countries (with China on the front line). The preeminence of Asian countries has been particularly steady since 2008, with a share of 60% to 71% of total funds raised in emerging markets. One should also notice that the share of Latin American and Caribbean countries significantly increased in 2010 and 2011 (respectively 24% and 22% whereas the arithmetic average from 2002 to 2008 was around 9%). On the other hand, the share of CEE & CIS and MENA in EM fundraising post-2008 significantly decreased (respectively 5% and 1% in 2011). Finally, Sub-Saharan Africa's share was historically low (average of 4%).

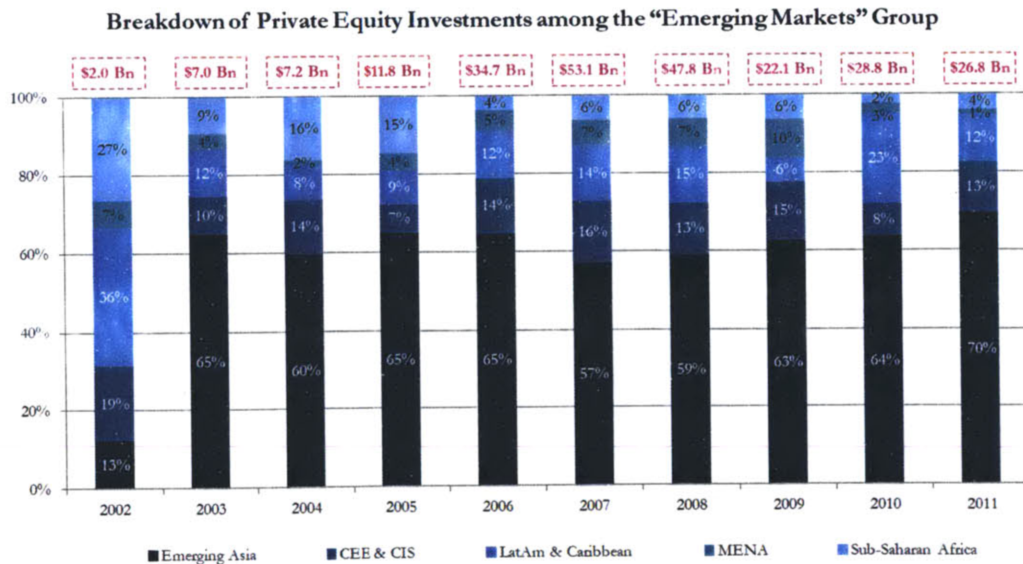
Figure 1.15



Source: EMPEA

Figure 1.16 confirms the dominance of PE activity by Asian countries as their share in total capital invested by far surpassed other emerging regions (average of 63% over 2003-2011 with a peak of 70% in 2011). Emerging Asian countries were followed by LatAm & Caribbean and CEE & CIS regions (each of them displaying a 2003-2011 average of 12% of the total PE capital invested in emerging markets). The MENA region and Sub-Saharan Africa captured the smallest portion of capital investments as they respectively displayed a 2003-2011 average of 5% and 8% of total investments while they represented only 1% and 4% in 2011.

Figure 1.16



Source: EMPEA

Figure 1.17 compares the different emerging regions on the basis of a ratio defined by funds invested over funds raised (at a certain year). A ratio superior to 1.0x indicates that the investment activity is "hotter" than the fundraising activity; on the contrary, a ratio inferior to 1.0x indicates that the fundraising activity is ahead of the investment activity. Several observations can be made:

- The ratio for the Asian region was the most stable over time and the closest to 1.0x (the arithmetic average over 2002-2011 is 1.0x), which means that the investment cycle parallels the fundraising cycle on average and that investment opportunities justify the high amounts raised in the region.

- The ratio for Latin America & Caribbean was historically above 1.0x (average of 1.2x over 2002-2011). Nevertheless, the region had the lowest ratio in 2011 (0.4x) due to a buoyant fundraising activity.

- The ratio for Sub-Saharan Africa was historically far above 1.0x (average of 1.62x over 2002-2011). One could reasonably infer that funds are put to work faster than they are raised. However, the fact that the ratio fell below 1.0x in 2010 and 2011 suggests that the dry powder in the region increased. In 2011, capital invested was as low as funds raised and the ratio dropped close to 1.0x.

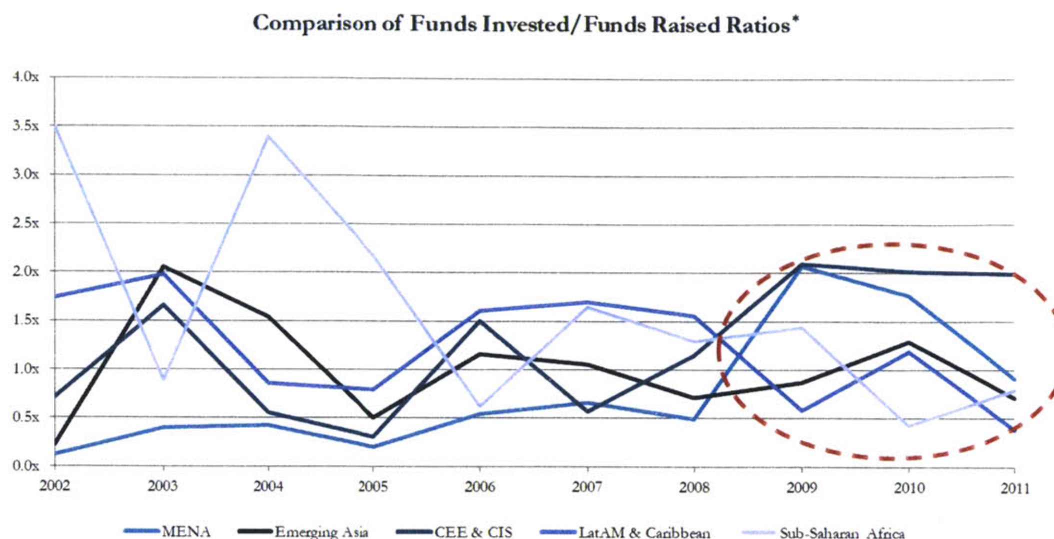
- The ratio for the MENA region was constantly below 1.0x from 2002 to 2008: fund managers in the region increased their dry powder with a "hot" fundraising activity relatively to capital effectively put to work. Nevertheless, the trend reversed in 2009 and 2010 due to a weaker fundraising activity.

- The ratio for CEE & CIS was quite volatile between 2002 and 2007 but it remained constantly above the 1.0x threshold from 2008 to 2011 (the highest ratio among the group in 2011 at 2.0x). This recent trend reflects investors' lower appetite for the region and funds formerly raised being invested.

Overall, emerging markets have been piling up dry powder as investment activity was lower than the fundraising activity when looking at the emerging group as a whole. As a matter of fact, dry powder in emerging markets has increased at a 32% compounded annual rate since 2005[11] (compared to 8% in Western Europe and 7% in the US).

[11] Bain, "Global Private Equity Report", 2012

Figure 1.17



Source: Based on EMPEA data
**Not adjusted for "noise" due to multi-region funds (lack of data)*

Drivers of PE Expansion in Emerging Markets

As private equity activity in emerging markets is gaining interest among the LPs community, it becomes essential to understand the underlying drivers of PE expansion in such markets. Moreover, this step is important to apprehend Tunisia's positioning in a later stage. In this regard, the central question should be: which factors, when combined, would trigger private equity deal flow in emerging markets?

Five building blocks can be seen as essential for the expansion of private equity in an emerging country[12]:

a) Availability of Funds

As previously developed, the private equity model is based on a basic GP-LP relationship: typically, a GP would seek funds from LPs in order to manage them in return for performance and management fees. Therefore, when funds provided by LPs are scarce, the private equity deal flow is weak. There are four types of potential LPs for fund managers seeking to raise capital targeting PE investments in emerging markets:

- Development financial institutions ("DFIs"): This group encompasses international development organizations whose first objective is to promote private sector investments in developing countries. Providing PE fund managers with capital to invest is one way for them to do so. They often play a crucial role in supporting first-time funds in emerging

[12] Based on an analysis conducted by the IFC ("Emerging Market Equity: Private Equity, Public Equity, Risks & Opportunities", World Pensions and Investments Forum 2012, Paris, 9 February 2012) and a report published by the Boston Consulting Group ("New Markets, New Rules", November 2010)

markets. Some examples of such institutions are the World Bank's International Finance Corporation ("IFC"), the European Bank for Reconstruction and Development ("ERBD"), the Overseas Private Investment Corporation ("OPIC"), the UK's CDC Group, and Germany's DEG.

- State-owned investment vehicles: Governments can play an essential role in PE expansion by devoting investment vehicles unlocking funds devoted to private equity. In this perspective, sovereign wealth funds ("SWFs") are expected to be on the front line (resources are estimated at $4.7 trillion in 2011[11]). The accumulation of cash in oil-rich economies (notably in the Middle-East), the surplus of foreign currency reserves in fast-growing economies (e.g. China) as well as the willingness of sovereign wealth funds to invest in alternative assets providing higher returns, should result in a higher inflow of funds toward PE funds in emerging markets from SWFs. However, while some of these SWFs aim at a global reach (e.g., Abu Dhabi Investment Authority, Kuwait Investment Authority), others are more focused in developing the PE sector in their home economies (e.g. Mubadala Development Company in Abu Dhabi, Temasek Holdings in Singapore)[11].

- Asset managers: This group is composed of financial institutions which have an asset management activity and whose main aim is to allocate investments in order to optimize their overall portfolio (private equity is one asset class in which they invest among others). Such a group of institutional investors typically includes private and public pension funds, insurance companies, foundations and universities (endowments).

- High-net-worth individuals: High-net-worth individuals can constitute potential LPs for PE fund managers in the sense that private equity constitutes one of the asset classes they would invest in to manage their fortune. However, individual investors are less reliable than institutional investors due to higher needs in liquidity and generally lower sophistication in asset management.

There are two main factors explaining global LPs' rise of interest in emerging markets: portfolio diversification (less exposure to developed markets and de-correlation) and access to emerging markets' fundamentals (stock markets are usually underdeveloped and do not give direct access to economic fundamentals). LPs often base their investment allocations on proven track records: good track records of PE funds in a country or region can sometimes be vital to sustain fundraising activity.

b) Economic Conditions for Investment Opportunities to Emerge

A market-based economy is essential to attract LPs' interest in private equity investments. As a matter of fact, entrepreneurial activities typically increase, companies within the range of PE ticket sizes emerge, private investments expand and "real" economic growth is not artificially sustained by government interventionism, services and products get more sophisticated while consumer demand is bolstered, management practices improve enough to be interesting for PE investments.

Economy openness is also an important factor to be taken into consideration. Less stringent trade barriers and capital control entail more competitive pressure and push domestic companies to meet international standards in terms of efficiency. The possibility to expand beyond national frontiers makes room for potential regional leaders to grow more substantially. The deal flow is stimulated as companies need more capital to expand offshore, improve operations and become more efficient, large conglomerates might be faced with the necessity to sell off non-core assets.

c) Scalability

Scalability is often decisive to attract capital from potential LPs as most PE investments in emerging markets are categorized as growth-capital private equity. The size of the population and the economy is a good proxy for the potential market (especially for B2C businesses): simplistically, small population and economy would cap potential for growth whereas large population and economy would offer portfolio companies with greater growth prospects. When the domestic market is limited, the economy needs to be at least open enough to allow potential regional expansion.

d) Structural Factors

The transparency and the stability of the legal system, investor protection and corporate governance are critical to measure private equity attractiveness. "Trust" makes it easier for GPs to raise money from foreign LPs, undermines fears from political and legal risks, gives a greater value to contractual agreements, and makes the due diligence processes easier.

An attractive fiscal system can provide incentives to domestic investors. The levels of corporate tax rate as well as the tax on dividends and capital gains are the fundamental elements defining "tax-attractiveness". From the perspective of foreign LPs, double taxation agreements are also essential to avoid additional layers of taxation.

The human and social environment is also an important element to consider for LPs as the cost of doing business in emerging markets is often higher than it is in developed markets. The flexibility of employment, the level of corruption, the overall level of education, the business costs of violence and crime are in this regard indicators assessing to some extent the quality of the human and social environment.

e) Banks and Capital Markets

The quality and sophistication of bank lending and debt capital markets facilitate investments in lower growth companies. The possibility of leveraged acquisitions can increase deal flow as slower growth companies become viable targets. However, an easy access to lending and an overwhelming availability of "bad" credits can distort capital markets and make it more difficult for PE investors to generate deals.

Stock exchange liquidity can help PE activity thrive as exit windows improve in the sense that IPOs generally provide better exit multiples. The development of stock markets improves exit conditions, increases return expectations, and therefore indirectly stimulates private equity deal flow.

Key Success Factors for PE Firms Operating in Emerging Markets

According to a study conducted by BCG (based on a dataset provided by the IFC), there are several differences between success factors for PE funds investing in developed markets and those investing in developing countries[13]. Several important inferences can be made:

[13] BCG Report, "New Markets, New Rules", November 2010

- Minority deals are more successful than majority deals. Most of the businesses in emerging markets are still in the early stage of their development. Owners typically want to keep control of the company that they are still developing. However, clear corporate governance often helps private equity investors to protect themselves from the lack of control.

- It is better to invest in businesses focusing in domestic markets rather than those targeting internationally-oriented companies. While there are good arguments for investments in internationally-oriented companies, the dataset provided by the IFC shows that companies focusing on their domestic market are on average outperformers. Such observation might be explained by the expertise and in-depth knowledge managers tend to have in their domestic market.

- It is important to identify industry cycles as some sectors in emerging markets can significantly outperform others in terms of returns. The IFC dataset shows that investments in telecommunications, healthcare and materials were clear outperformers. While the analysis of potential trends in individual sectors is essential for GPs' investment thesis, sector specialization in emerging markets can be risky since potential uncertainties can be magnified by a lack of diversification.

- First-time funds in emerging markets perform well as they match and sometimes exceed returns achieved by experienced fund managers. The IFC dataset unexpectedly shows that first-time managers delivered very decent results since 46% of the top-quartile performers were first-time funds and first-time fund managers delivered on average approximately the same performance as experienced GPs.

- Funds with a local presence are much better performers than international funds without any local presence. They delivered returns on average five times higher than funds without local offices. In this regards, local presence enables fund managers to strengthen their domestic network and have a better understanding of specific socio-economic conditions.

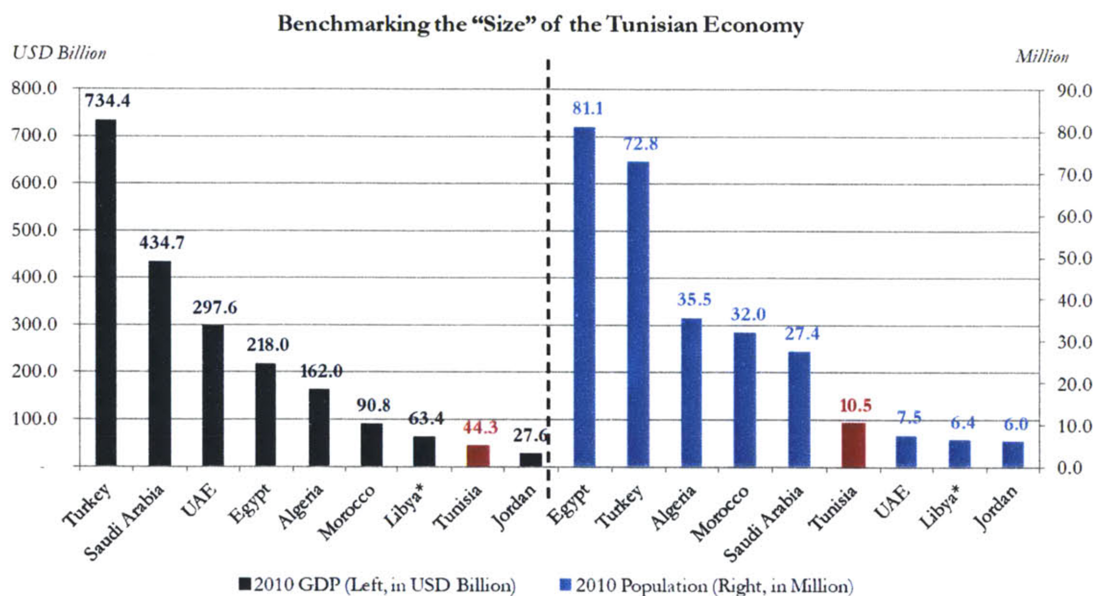
- Top-line growth is the main driver of strong performance among top-quartile funds. The IFC dataset suggests that superior returns delivered by top-quartile funds are driven by revenue growth rather than leverage.

- Bigger funds outperform smaller ones according to the IFC dataset. This observation suggests that bigger funds allow GPs to build stronger ties with local businesses. However, diseconomies of scale might be triggered if the funds become "too" big relatively to the absorption capacity of local businesses. Moreover, medium-sized investments provided better returns on average than small investments: the mid-cap market in emerging countries seems to have a better risk-return profile than the small-cap market.

A) Macroeconomic Fundamentals

With 10.5 inhabitants and a gross domestic product ("GDP") of $44 billion in 2010, Tunisia is a relatively small country. In this regards, Figure 1.18 compares the "size" of the Tunisian economy to its Middle-Eastern and North African neighbors. The relatively low GDP mirrors the limited capacity to absorb investments, especially when compared with much bigger economies such as Turkey, Saudi Arabia, UAE and Egypt or to a lesser extent Algeria and Morocco. This is notably due to a relatively modest population (which limits the market reach for investors) but also to a lack of natural resources comparatively to countries such as Saudi Arabia, UAE or Algeria.

Figure 1.18:



*GDP as per 2009 for Libya

Source: World Bank

However, when Tunisia is compared to its neighbors in terms of GDP at purchasing power parity per capita (which is often considered as a good proxy of the standard of living), it turns out that is fairly well positioned (Figure 1.19). It should be noted that the high GDP per capita PPP in UAE, Saudi Arabia and Libya is significantly biased by the preeminence of natural resources (essentially oil and gas) in their economies. Moreover, the proactive education policy undertaken in Tunisia since 1966 significantly decreased the illiteracy rate (people ages 10 and above) from 51% in 1966 to 19% in 2010[14]; the Tunisian population is highly educated relatively to the region's standards.

However, the relatively high levels of standard of living and literacy rate should not hide the internal disequilibrium prevalent in Tunisia.

[14] IDEES, report on the unemployment in Tunisia, 2012

- By the end of 2011, the unemployment rate reached 18.9% at the national level and 30.5% for those with university degrees[15] (with even higher rates in underdeveloped regions).

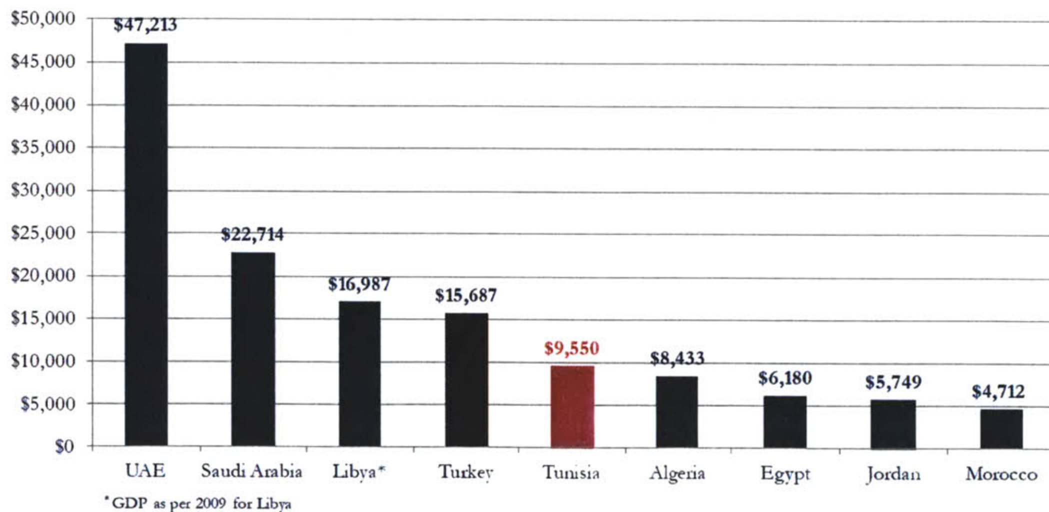
- The poverty rate is standing at 25% (share of citizens living with less than 2$ per day)[16].

- The disparity between the illiteracy rate in rural regions and urban areas is significant (respectively 31% and 13%)[14].

- The economy is dual with a notable regional disequilibrium and a severe fracture between coastal regions and inland areas.

While the social and economic instability subsequent to the Tunisian revolution has exacerbated this internal disequilibrium, it also revealed that it had been already very severe under the regime of the ex-President Ben Ali.

Figure 1.19:



Source: World Bank

The GDP growth of Tunisia fell in the 5-6% range over 2003-2007 and in the 3-4% range over 2008-2010 (Figure 1.20). While the growth profile does not seem as attractive as in some emerging countries displaying GDP growth closer to 10%, the "growth story" remains attractive compared to developed markets and the economy proved to be relatively resilient to the global recession (before the uprising in 2011). Nevertheless, the social and economic instability following the 2011 revolution severely hit the overall economy as the GDP is estimated to have fallen by 2.2% in 2011. Tourism and the phosphate industry, two key sectors in the Tunisian economy, were particularly harmed. Despite the drawbacks and internal instability suffered by the country, the 2012 budget released by the Ministry of Finance remained optimistic about the growth prospects in 2012 (first set at 4.5% then revised at 3.5%).

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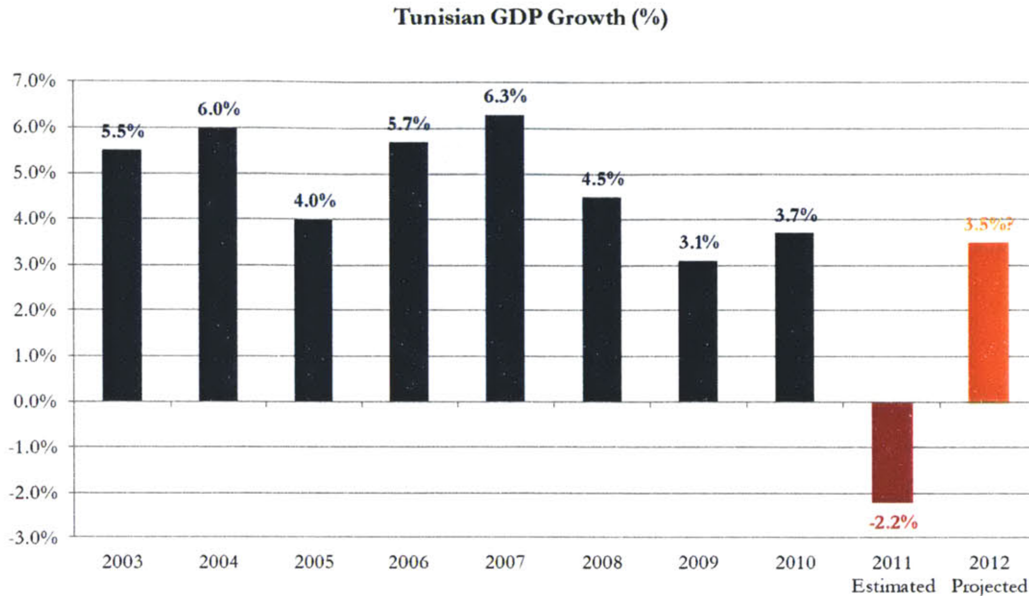
[15] National Institute of Statistics ("INS")

[16] Tunisie Valeurs, "Revue de Recherche", February 2012

Figure 1.20:



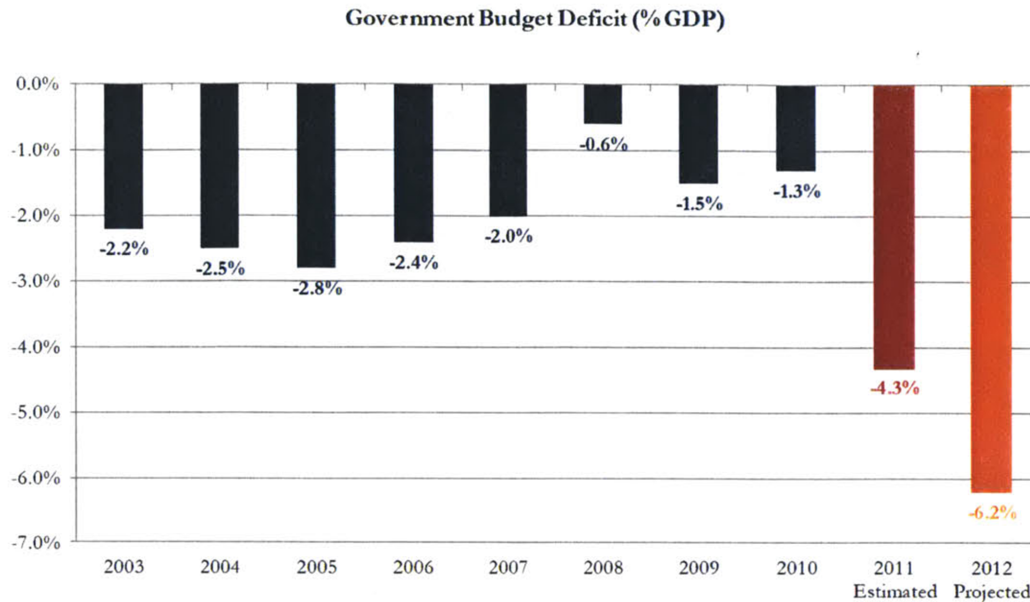
Source: World Bank until 2010, Tunisian Central Bank for 2011 estimate, Tunisian Ministry of Finance (2012 budget) for 2012 projection

The country's current account deficit was also negatively impacted by the recession (from 1.5% of the GDP in Q1 2011 to 2.3% in Q1 2012) as imports increased faster than exports (respectively 21.6% and 9.1%). The overall deficit of the balance of payments was lower than in Q1 2011 due to an increase in financial accounts (mainly *via* foreign direct investments and public indebtedness). As a consequence of account deficits, the Central Bank reserves depleted from 113 days of imports at the end of 2011 to 101 days in Q1 2012[17], which might be seen as an alarming sign of vulnerability regarding the Tunisian currency (the relatively long term nature of foreign capital mainly composed of foreign direct investments and long-term debt is reassuring tough).

As displayed in Figure 1.21, the government budget deficit had been historically low until the revolution hit the country. The deficit went from -1.3% in 2010 to -4.3% in 2011. In the 2012 budget, the government expects it to reach -6.2% in 2012 (above the threshold of -5% usually seen by economists as the "psychological" threshold). This element might appear even more alarming when one notes that government projections of GDP growth (3.5% in 2012) and tax collections are optimistic.

[17] Tunisian Central Bank, "Conjoncture économique et financière nationale: principales évolutions jusqu'au 16 avril 2012" (National economic and financial situtation: main evolutions until April 16,2012), 2012

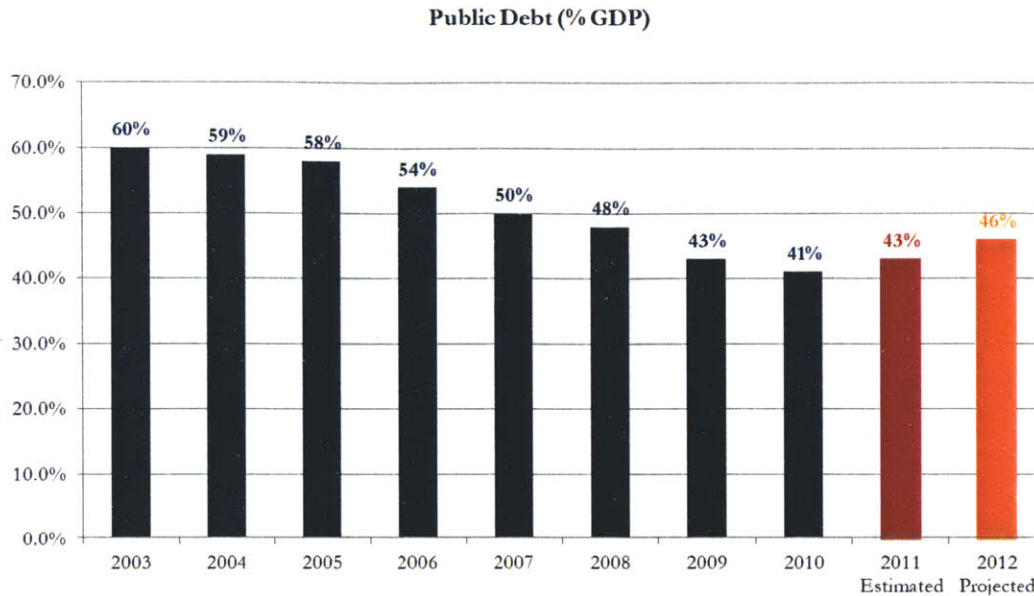
Figure 1.21:



Source: World Bank until 2010, Tunisian Central Bank for 2011 estimate, Tunisian Ministry of Finance (2012 budget) for 2012 projection

The Tunisian public debt to GDP ratio decreased from 60% in 2003 to 41% in 2010 (Figure 1.22). The trend inverted in 2010 (ratio of 43%) and is expected to follow the same direction in 2012 (the ratio is expected to rise to 46%). Based on the criteria of economic orthodoxy (the European Maastricht Treaty sets the level of acceptable indebtedness to 60% of GDP) and the current world's ratio (estimated at around 70% by the IMF), such levels of indebtedness seems to be sustainable. The low leverage of the country should give the government some room for manoeuvre to finance the nation's deficits and the investments needed to help the economy recover.

Figure 1.22:



Source: World Bank until 2010, Tunisian Central Bank for 2011 estimate, Tunisian Ministry of Finance (2012 budget) for 2012 projection

B) Investment Environment

Revolution and Investor Confidence

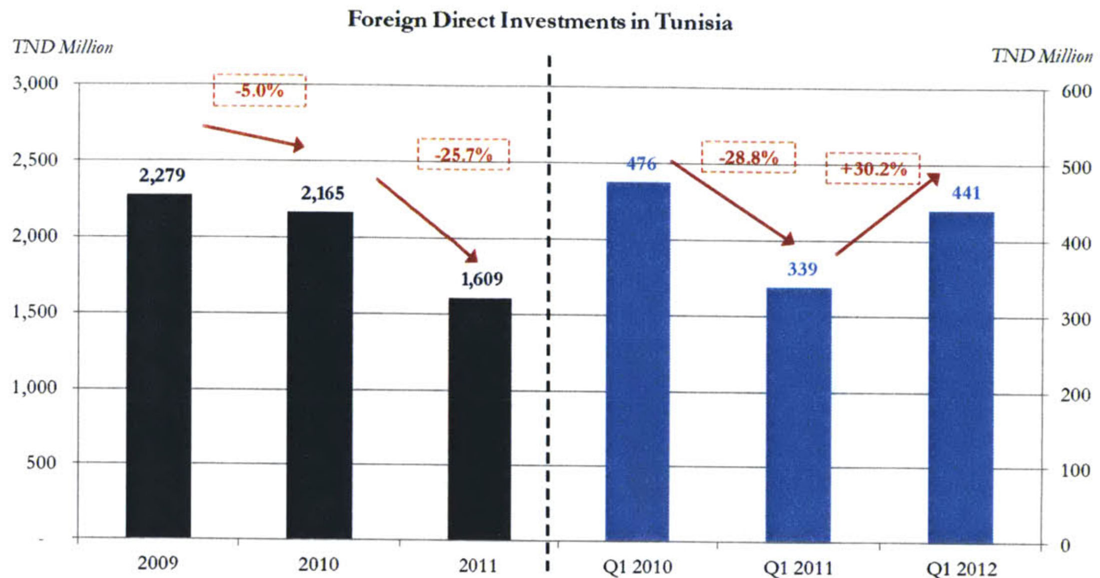
An increase in the CDS spread of government bonds (cost of insurance) and a credit downgrade are often seen by foreign investors as appealing signs of increased investment riskiness. In this regards, S&P and Moody's cut the credit rating of Tunisia by one notch while CDS spreads increased from 120 bps (13th January 2011) to 275.5 bps (9th December 2011)[18]. However, indicators on the activity of foreign investors reflect even better the perception of the country by the investment community. While portfolio investments (in stocks, bonds or other liquid securities) are not "reliable" inflows of capital, foreign direct investments ("FDIs") not only are a stable source of foreign capital for the Central Bank but also contribute to productive investments in the economy. Foreign direct investments represent a substantial source of capital inflows for the Tunisian Central Bank; according to the World Bank's dataset, FDIs represented on average 5.2% of the Tunisian GDP between 2006 and 2010. Moreover, FDIs have by far the largest share in foreign investments (on average 95% *versus* 5% for portfolio investments between 2006 and 2011).

The economic and social instability following the revolution in January 2011 seems to have spread fear among the foreign investor community. As displayed in Figure 1.232, FDIs dropped by 25.7% in 2011[19]. Some key sectors were more particularly hit by the decline in FDISs: -83% drop in tourism, -42% in manufacturing and -19% for energy.

[18] Gulf Research Center

[19] The Foreign Investment Promotion Agency (FIPA), "FDI Performance during 2011", 2012

Figure 1.23:



Source: The Foreign Investment Promotion Agency, FIPA-Tunisia

There is a good case to make that the decrease in foreign investments and the increase in trade deficits are partly attributable to the Eurozone crisis (Europe represents nearly 80% of Tunisian exports), but there is no doubt that the uncertainty subsequent to the Tunisian revolution has severely challenged investor confidence and has put Tunisia in the spotlight.

The interviews conducted among the business community lead to the same conclusion: most investors are currently in a wait-and-see position. Several factors explain skepticism among investors:

- The current social environment is still very unstable (illegal and violent strikes, strong decrease in productivity).
- The Islamic party in power raises suspicion among the investment community.
- The government's ability to solve the economic and social issues is nothing but granted.
- There is a significant uncertainty about future developments in Libya.
- Sales in 2011 were below companies' previsions (as stated by 62% of the companies interviewed in a research conduct by Ernst & Young[20] between April and May 2011). The underperformance is mainly due to the decrease in internal demand and exports, the disruptions in supply chain and distribution channels, production issues (staff strikes) and delivery problems.

Uncertainty also creates hopes about future developments as a new democratic environment is potentially a positive progress towards more transparency, less corruption, and *in fine* a more business-friendly environment. The new government has shown some signs that it is willing to

[20] Ernst & Young, "Revolution Opportunities", 2011

restore investor confidence; when he was appointed as the new Minister of Industry and Trade in December 2011, Mr. Mohamed Lamine Chakhari, officially declared that one of the current government's priorities will be to restore confidence amongst Tunisian and foreign investors as well as stimulate investments in inland areas. Even though there is no clear communication strategy yet, the positive energies created around the Tunisian revolution have resulted in a willingness to restore investor confidence. As a matter of fact, Christine Lagarde, the Managing Director of the International Monetary Fund ("IMF"), visited Tunisia in February 2012 and made it clear that the IMF was ready to help the country restore confidence among the investment community and evoked the possibility of a loan. The Tunisian Investment Forum organized on the 17th of June 2011 under the leadership Beji Caid Essebsi (the Prime Minister in charge before the election of the Constituent Assembly) is an example of communication initiatives the current government can pursue in order to revitalize investment in Tunisia. The year 2012 started in a more positive note as FDIs increased by 30% *versus* Q1 2011 (Figure 1.23).

Investment Attractiveness of Tunisia

Despite the current instability and the relatively small size of the Tunisian economy, there are several arguments to make in favor of investing in Tunisia.

The country has a strategic position in the Mediterranean area and is at the crossroads of Europe, the Middle-East and Sub-Saharan Africa. Some tools for economic cooperation are already in place (free trade agreement with the European Union, Arab Mediterranean agreement, free trade agreement) but more integration is needed with North African, Middle-Eastern and Sub-Saharan countries in order to leverage such position.

Based on the Global Competitiveness Report published by the World Economic Forum[21] (Figure 1.24), Tunisia compares extremely well with its neighbors as it is ranked 1st among South Mediterranean countries and 40th worldwide (in front of Italy).

In terms of basic requirements, its high score of 5.05 out of 7.0 reflects particularly the solidity and quality of its infrastructure (9 airports and 7 commercial seaports to connect the country to the rest of the world, fairly efficient internal communication and transport infrastructure even though inland areas are not very well connected yet, service infrastructure at competitive rental costs), the strong macroeconomic fundamentals (at least prior to the revolution), the high quality of its health infrastructure as well as the high level of primary education, the relatively good quality of its institutions, the relatively solid legal and regulatory framework (freedom of investment in most of the sectors; free transfer of profits, capital and capital gains, simplified procedures for business creation, fiscal incentives for companies which export and/or invest in underdeveloped regions).

Tunisia is also relatively well-positioned regarding "efficiency enhancers". More specifically, skilled labor is available (65,000 new graduates of higher education per year[22], diverse programs to improve employability and reduce unemployment); the goods market is fairly efficient (business productivity, attractiveness for FDIs, healthy market competition, demanding consumers); the expansion of financial markets is on the right path; the labor market is more efficient and flexible than it is in other countries despite the high level of unemployment rate; there is a good understanding and use of technology (especially information and communication technology, or "ICT").

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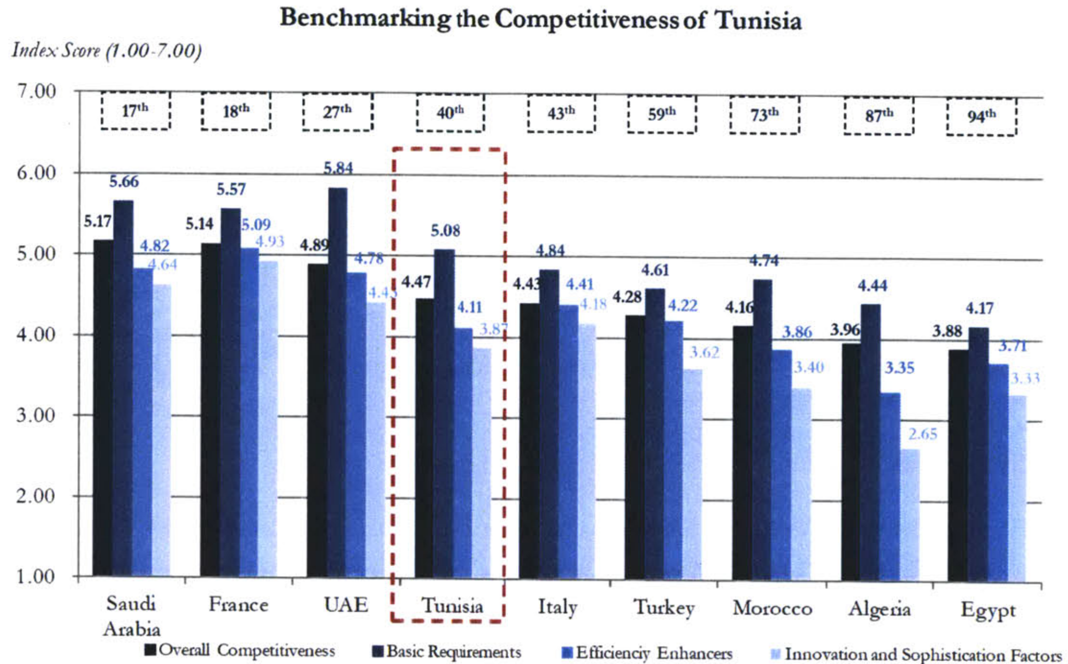
[21] World Economic Forum, "The Global Competitiveness Report 2011-2012"

[22] The Foreign Investment Promotion Agency (FIPA), "New Tunisia, New Opportunities", 2012

In terms of innovation and business sophistication, Tunisia is also in a better position than its South Mediterranean neighbors (notably Algeria, Morocco, Egypt and Turkey). Even though its business sophistication does not meet the standards of developed markets yet, the overall quality of business networks as well as firms' operations and strategies is good. Its innovation potential is also promising (availability of recent technologies; availability of engineers and scientists; 30 R&D centers and 28,000 researchers; 10 existing poles of competitiveness and 14 planned[22]; strong potential in computer science, pharmaceuticals and ICT).

Figure 1.24:



Source: World Economic Forum, "The Global Competitiveness Report 2011-2012"

2. Specific Features of Private Equity in Tunisia

1) Why is Private Equity Important for Tunisia?

While banks' financing are "passive" investments, private equity funds typically invest in equity or equity-like securities and aim to be active investors. As a consequence, they contribute in many ways to improving the management of portfolio companies.

- They typically enhance good practices and procedures. Proper corporate governance is put in place and more transparency is internally promoted. Accounting standards and internal control are improved.

- They help improve the capital structure of companies. Most of Tunisian companies are indeed abnormally overleveraged as relatively well-performing companies have easy access to debt financing and shareholders often dry up their company's treasury. Growth capital private equity capital would help de-lever portfolio companies.

- Banks are much more risk averse than private equity investors. The latter are willing to put capital more at risk and support development objectives.

- Private equity investors bring their expertise, experience and contacts in order to help companies scale up, grow rapidly and become more efficient.

- Most importantly, contribution to companies' growth also improves social development (and creates particularly more jobs) and can increase government tax revenues even when fiscal incentives for PE investments are in place.

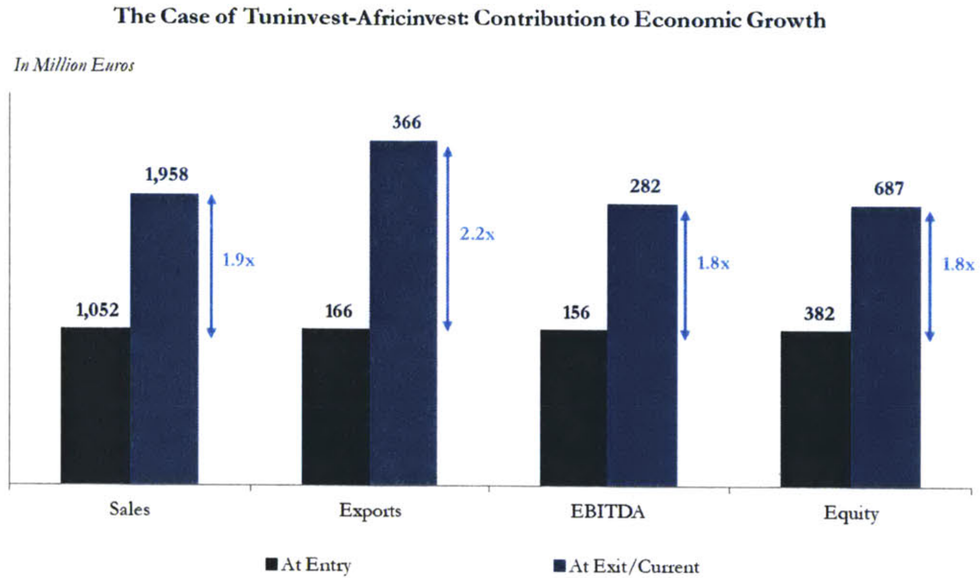
The analysis of Tuninvest-Africinvest's pan-African portfolio (of which Tunisian companies) provides a good illustration of private equity investors' contribution to economic growth, tax revenues and social development[23].

Figure 2.1 shows the improvement of several economic indicators for Tuninvest-Africinvest's portfolio companies. Sales, exports, EBITDA and equity value more or less doubled. When the analysis is limited to companies held for at least two years, the contribution is even higher:

- Sales were multiplied by 2.4x (CAGR of 16%)
- Exports were multiplied by 3.2x (CAGR of 21%) despite the recent decrease in exports to OECD countries
- EBITDA increased at a CAGR of 21% (higher than sales' growth, which indicates an improvement in margins and productivity)

[23] Tuninvest-Africinvest's presentation available on the website of African Development Bank, June 2011

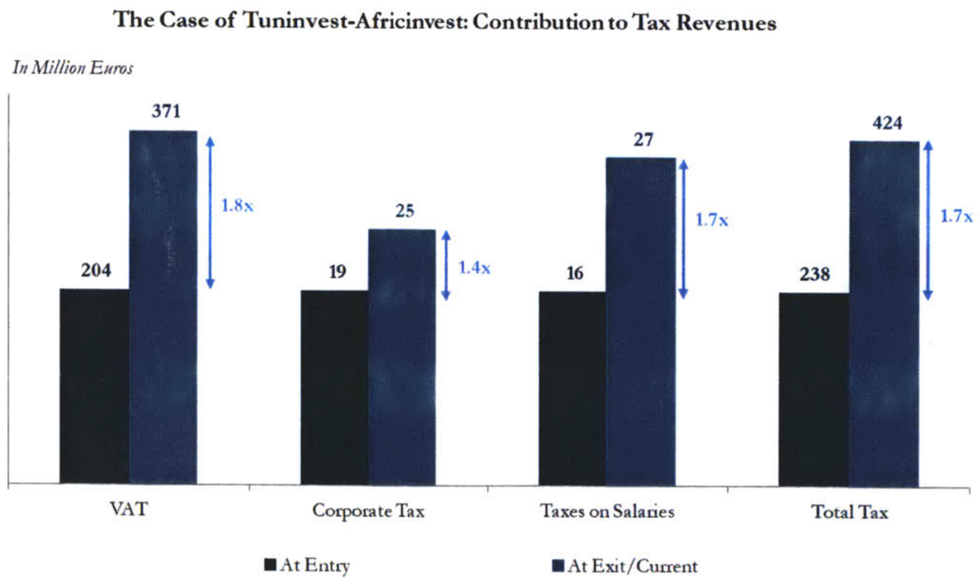
Figure 2.1:



Source: Tuninvest-Africinvest's presentation available on the website of the African Development Bank, June 2011

At the level of portfolio companies, Tuninvest-Africinvest's private equity investments contributed to tax revenues of national governments through higher growth of employment and taxable income (Figure 2.2). When the analysis is limited to companies held for at least 2 years, total tax contributions grew on average 2.2 times (CAGR of 15%) despite the tax rebates meant to promote exports in many countries.

Figure 2.2:

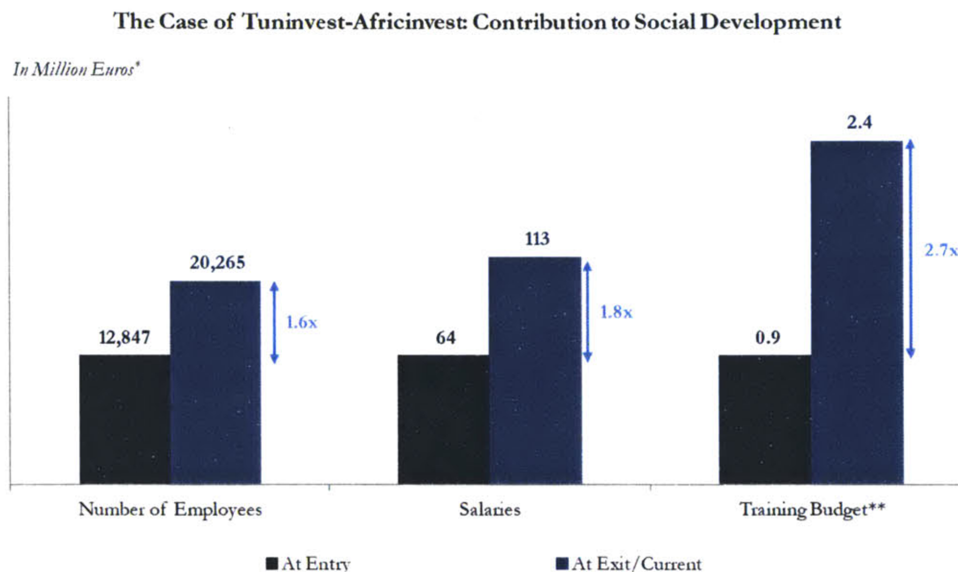


Source: Tuninvest-Africinvest's presentation available on the website of the African Development Bank, June 2011

Tuninvest-Africinvest's private equity investments have strongly contributed to social development as data on number of employees, salaries and training budget shows (Figure 2.3). The impact is even greater when the analysis is conducted for portfolio companies held for at least two years:

- Staff size grew by 86% on average during the holding period
- Total salaries were multiplied on average by 2.2x (CAGR of 14%)
- Training budget was multiplied on average by 3.3x for companies reporting training budget data

Figure 2.3:



Source: Tuninvest-Africinvest's presentation available on the website of the African Development Bank, June 2011

2) Overview of Private Equity in Tunisia

A) Domestic Private Equity Funds

In Tunisia, the private equity sector started developing in 1995 through domestic investment vehicles called "SICARs" ("Société d'investissement à Capital Risque" in French, or "Investment Company in Risk Capital" in English). In 2005, a new type of funds, "FCPRs" ("Fonds Commun de Placements à Risques" in French, or "Private Equity Mutual Funds" in English), was launched. These two forms of investment vehicles currently constitute the landscape of domestic private equity players in Tunisia. The "ATIC" (Association Tunisienne des Investisseurs en Capital" in French, "Tunisian Private Equity Association" in English) currently counts 42 active members (SICARs and companies managing FCPRs). While FCPRs are still relatively underrepresented, SICARs can be broken down into four main groups: SICARs launched by financial institutions, SICARs created by non-financial groups, regional SICARs, and independent SICARs.

Legislation Regulating SICARs and FCPRs

The creation of SICAR firms is mainly regulated by a law established in 1995 (Law Nr. 95-87). The main characteristics of SICARs are as follows (the modifications recently introduced *via* the two statutory laws, Nr. 99 and 100, published in October 2011, are not taken into account at this stage):

- SICAR companies aim to consolidate Tunisian companies' equity by investing their own funds or funds provided by third parties.

- Their resources are constituted by their own equity as well as funds deposited by public or private third parties. The total funds should be at least equal to TND 500,000.

- They intervene by way of subscription or through the acquisition of a range of securities as determined by the legislation in force. This group of securities encompasses common shares, preferred shares without voting rights, investment certificates, and convertible bonds.

- Investments must be subject to an agreement with target companies; such agreement shall define the terms of entry, monitoring and exit.

- They are not allowed to have a majority stake in portfolio companies.

- They have a legal requirement on the use of their capital; at least 65% of the contributed capital needs to be invested by the end of the fiscal year following the year of the capital contribution (by investors) within the scope of the following list:
    - Companies having activities in underdeveloped regions as defined by the Investment Code
    - New projects in small and medium-sized companies (companies are considered as "SMEs" if they have less than TND 4 million in net fixed assets and less than 300 employees)
    - Start-up companies managed by "new" entrepreneurs (one of the criteria is that the project must be the first entrepreneurial experience for the entrepreneur)
    - Companies investing in the promotion or the development of new technologies in the economic sectors defined by the Investment Code, or in the "ICT" sector (Information and Communications Technology)
    - Investment in the upgrade of companies within a program authorized by a public comity ("Comité de Pilotage")
    - Turnaround investments targeting companies facing a difficult situation

The creation of FCPR funds is mainly regulated by a law established in 2005 (Law Nr. 2005-105). The main characteristics of FCPRs are as follows:

- FCPRs are security investment mutual funds managed by a separated company.

- They have the same activity scope and legal requirements as SICARs.

- They aim to manage funds provided by third party investors for a pre-determined period (funds shall be liquidated). The minimum amount required for initial contributed funds is TND 100,000.

- Upon liquidation, initial funds and potential capital gains shall be distributed to investors as determined by an initial agreement. A lock-up period during which investors are not entitled to redeem their funds shall be pre-agreed.

Fiscal Incentives

The development of domestic private equity funds in Tunisia has been mainly triggered by fiscal incentives put in place. Such fiscal incentives are two-fold for investors in SICARs or FCPRs (prior the promulgation of the two statutory laws in October 2011):

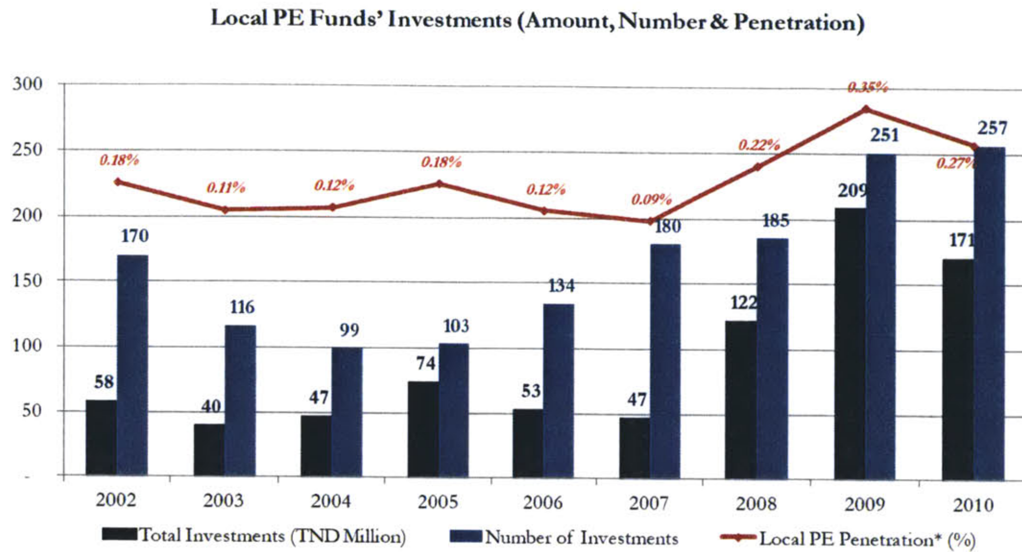
- Incentives at entry:
    - Tax relief with a minimum tax payment (20% tax rate for corporations) and a limit of 35% of the taxable income eligible to such treatment
    - There is neither a minimum tax payment nor a limit for income to be reinvested for investors if the SICAR (or FCPR) invests more than 75% of the contributed capital in underdeveloped regions as defined by the Investment Code
    - Conditions to take advantage of the tax relief:
        - Providing the tax administration with a written proof from the managing company showing either that the capital provided has indeed been invested according to the conditions underlying the fiscal advantages, or that the managing company intends to do so within one year from the date of the capital contribution or placement
        - No capital redemption or reduction for at least 5 years
        - No tangible guarantees provided by the portfolio company or its shareholders in order to secure the investment
        - The investment shall not be subject to payments uncorrelated to the results of the company

- Incentives at exit:
    - Full tax exemption of capital gains
        - Otherwise, for physical persons domiciled in Tunisia, capital gains are taxed at a rate of 10% (after deduction of capital losses); they are taxed at the marginal corporate tax rate (30%) for moral persons (after deduction of capital losses)

Domestic PE funds' activity

As displayed in Figure 2.4, the investment activity of (domestic) Tunisian PE funds started taking off in 2008. Not only investments increased from TND 47 million to TND 171 million (CAGR of 54% p.a. with a peak of TND 209 million in 2009) but (domestic) PE penetration (which is a common indicator of PE weight in the economy) soared as well (from 0.09% in 2007 to 0.27% in 2010 with a peak of 0.35% in 2009). While an increased awareness of fiscal incentives and a progressively less constraining legal framework might explain such take-off, the figures are biased to some extent: a significant portion of those investments considered as "PE" investments are debt-like investments (cf. carrying agreements below) and diverge from the industry standards. Besides, the number of investments increased at a slower pace, which resulted in an increase in the average target size, from an average of c. TND 420k over 2002-2007 to an average of c. TND 720k over 2008-2010. This shift translates the expansion of growth capital investments versus VC investments.

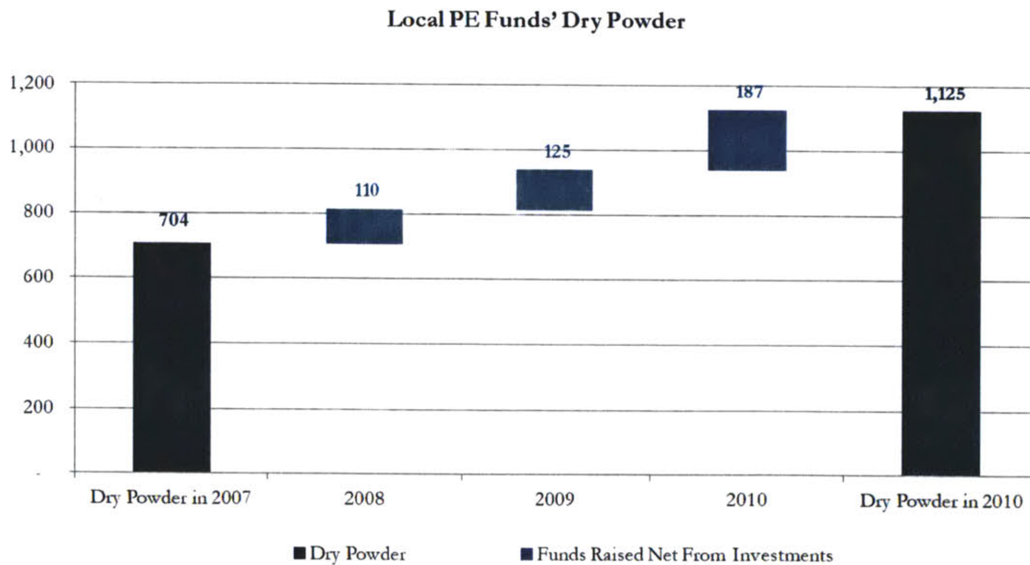
Figure 2.4:



Source: ATIC, Finance Minister, World Bank

Figure 2.5 shows that the accumulated dry powder of domestic PE funds between 2007 and 2010 grew at a fast pace (17% CAGR), which mirrors investors' increased willingness to commit capital in domestic PE funds.

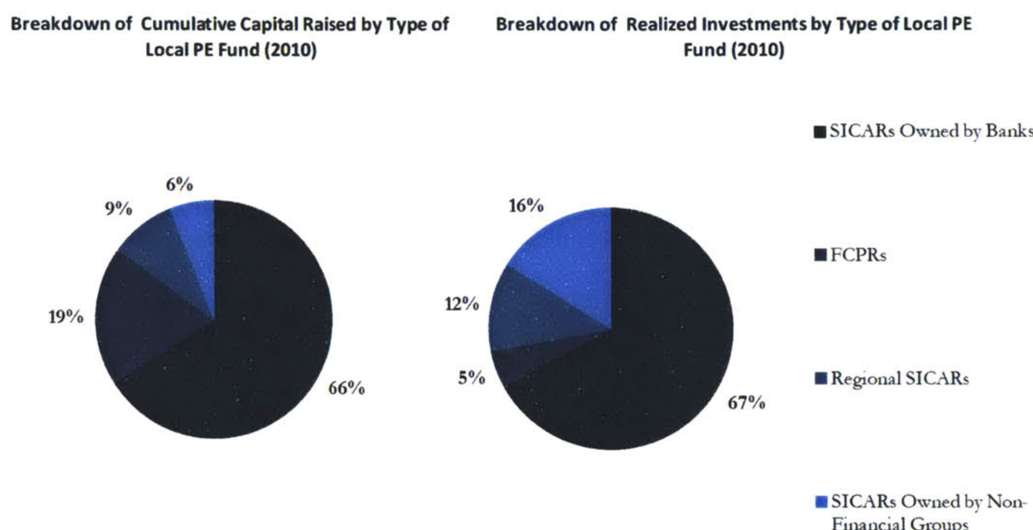
Figure 2.5:



Source: ATIC

Figure 2.6 shows that the sector is overwhelmingly dominated by SICARs owned by banks. In 2010, they accounted for 2/3 of the total activity both in terms of dry powder and realized investments. However, FCPRs are expected to have more importance over the next few years as they offer more advantages. More specifically, their share in realized investments is expected to grow significantly. They represented 1/5 of the total cumulative capital raised versus only 5% of the total investments made in 2010.

Figure 2.6:



Source: ATIC

Shortfalls of the System in Place before October 2011

Experts in Tunisia agree that the vast majority of domestic private equity funds are not "real" private equity players and that the expected results in terms of economic impact have not been reached. The shortfalls of the current system in place are developed below.

a) The typical GP-LP relationship is not in place

First, the dynamics under which a team of private equity professionals forms and aims to raise funds among the LP community is inexistent. Independent managing companies are scarce and most of SICARs are launched at the initiative of a unique institution or a limited pool of institutions (financial institutions or "big" non-financial groups). The recruited managing team usually has no experience in private equity, or more generally asset management (typical managers have a career in retail banking or an industrial expertise). Traditionally, the fundraising period (fund structuring, marketing, negotiation with investors, fund setup) is fundamental in the sense that it structures the team and sets clear objectives. The inverted relationship in SICARs and FCPRs (with investors setting up the fund from the outset) kills such dynamics.

Second, the way funds and compensation are structured does not incentivize funds' managers. In the case of SICARs, two compelling examples can be evoked: the absence of carried interests as a way of compensating fund managers and the inconsistency of funds' lifecycle.

In a typical GP-LP relationship, LPs make sure that the fund managers are incentivized enough to provide the best return possible. In order to do so, they give up a share of the profits as a way to compensate managers (usually 20% of the capital gain in the simplest cases). On the contrary, SICAR managers are generally paid a fixed compensation regardless the returns they generate, which obviously provides less incentives to generate good returns.

The inconsistency of funds' lifecycle worsens the lack of incentives for managers to generate good returns. On the one hand, there is no pre-agreed liquidation date; shares are redeemed and dividends are paid over time; the fund can also be replenished by fresh equity. Therefore, managers do not have any pressure to stand out with a good track record in order to raise next funds as it is the case in typical PE funds. Besides, the theoretically indefinite life of the fund exacerbates the lack of incentives for managers to actively seek attractive exits while the higher duration of held investments might affect negatively IRRs. On the other hand, it is very common that 100% of the funds subscribed by investors are delivered upfront. Usually, investors should commit their capital at the initiation of the fund; fund managers would call part of those funds as deals are progressively generated. Consequently, domestic PE fund managers become asset managers and it is very frequent to see on the balance sheet significant investments in stocks, other mutual funds, etc.

Third, SICARs are at the same time funds and managing companies. Indeed, they are typically set up as "SA" ("Societe Anonyme" in French), which is the equivalent for the US Corporation. Such setups often create conflict interests as investors typically have a seat on the board of the SICAR and would influence managers' investment decisions.

As a consequence, a law promulgated in 2005 established the legal framework for FCPRs in order to overcome part of such shortfalls. FCPRs have the same fiscal advantages and scope of activity as SICARs but they have a different legal status: they are not considered as "moral persons" in the sense that they need to be managed by an independent managing company and they also have a finite life. They need to be authorized by the "CMF" ("Conseil du Marche Financier", the equivalent for the SEC in the US). Such structures encourage a more incentivizing compensation for managers.

The comparison of different funds in Table 2.1 shows that the practice has improved since FCPRs have been introduced.

Table 2.1:

Name of the Fund	Tuninvest SICAR	Tunisian Development Fund	FCPR-F.P.PME	ATID Fund (I)	FCPR Valeurs Developpements	Fidelium Essor	Phenicia Seed Fund
Launch Date	1994	2010	2010	2010	2010	2010	2007
Managing Company	Tuninvest	UGFS-NA	SAGES Capital	ATID Co.	Tunisie Valeurs	Fidelium Finance	Alternative Capital Partners
Investors	Tunisie Leasing (36.5%); free float (63.5%)	NA	NA	Al Barak Bank, others (?)	8	STB, BNA, Cab de Phare, 2 others	European & Tunisian institutional inv;: e.g. BEI, CDC, ATB, Amen Bank, BH, ATL, GAT
Deposit Bank	NA	BIAT	STB	Al Baraka Bank	Amen Bank	BIAT	ATB
Target Capital	TND 10.0 Million	TND 15.0 Million	TND 25.0 Million	TND 50.0 Million	TND 3.0 Million	TND 10.5 Million	TND 10.0 Million
Initial Capital	TND 10.0 Million	TND 15.0 Million	NA	TND 50.0 Million	TND 3.0 Million	TND 1.0 Million	TND 10.0 Million
Investment Approach	Various sectors in Tunisia	Min. 75% in underdeveloped regions (NTC, pharma, agri, etc.)	Min. 65% in industrial upgrade projects, other FCPRs	Min. 65% CII, Max. 20% distribution, max. 15% real estate, all development phases	Min. 65% CII, max. 50% in the same sector, max. 15% same company	Min. 60% in target cities (Sfax, Mahdia, Gabes, Monastir) for VC and growth capital	Seed (min. 50%)/early VC investments, 15-20 investments, 4-6 years holding, max. 30% same sector
Ticket Size	Average TND 500k	Min. TND 500k	TND 100k – 5,000k	TND 500k – 7,500k	TND 200k – 450k	NA	TND 200k – 1,000k
Fund Life	Undefined	10 years	10 years	10 years	7 Years	10 years	10 years
Potential Life Extension	NA	2 years	2 years	2 years	2 Years	2 years	2 years
Lockup Period	NA	Life-period	Life-period	Life-period	5 years, 4% NPV penalty if redeemed in 2016, 3% if in 2017	NA	Life-period "recommended"
Capital Redemption/Reduction	Yes, c. TND 8.0 million distributed	Excluded	Excluded	Excluded	Excluded	Not excluded	Not Excluded
Other Asset Classes Held	Yes	NA	Yes (government bonds)	Yes	Yes (stocks, government bonds): c. 23% of net assets as of 31-Dec-10	Yes: 100% of listed stocks & SICAV as of 31-Dec-10 (??)	Yes (government bonds, mutual funds); 35% of net assets as of 31-Dec-2009
Management Fees	NA	2.5% on invested capital, 1% on reminder	Between 1.0-1.75% on invested capital	1.5% on net assets	2.0% on committed capital	3.5% on committed capital + investment fees (max. 1.0%)	3.5% on committed capital minus acquisition cost of exits/write-offs
Performance Fees	NA	20% of net profits above IRR of 10%	50% of net profits above IRR of 8%	10% of net profits (at the end of fund's life)	20% above 55% IRR (at the end of fund's life)	No	25% of capital gains corresponding to a 6% hurdle rate, 20% of reminder
Dividends	0%	0%	0%	0%	0%	0%	0%
Capital Gain Tax	None if conditions fulfilled	0%	0%	0%	0%	0%	0%
Tax Relief Up-Front	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Source: Public data released by the CMF (mainly prospectuses and financial statements)

- Most of funds are set-up for a <u>10-year period</u> with 2 years of potential life extension.

- <u>Contributed capital is locked-up</u> for at least 5 years (in order to take advantage of the tax relief up-front).

- A <u>team dynamics among fund managers</u> seems to have developed. Some of them are acting more like fundraiser as they pitch several investors in order to make them commit PE capital. For example, the fund managers of Alternative Capital Partners ("ACP") managed to have a number of European institutional investors (such as the European Investment Bank and CDC Entreprises) and Tunisian institutional investors (of which large banks such as the Arab Tunisian Bank, the Amen Bank, the Bank de l'Habitat, and Insurance or Leasing companies such as the Arab Tunisian Lease, the Groupe des Assurances de Tunisie) to commit TND 10 million in the seed/early VC fund raised in 2007 ("Phenicia Seed Fund"). The capital was planned to be called and contributed over time (4 contributions of TND 2.5 million). The team also co-manages the EUR 75 million small-cap fund raised by the French Viveris Management; ACP team takes care of

investments in Tunisia (and potentially Algeria and Egypt) while two other teams manage investments in Turkey and Morocco.

- Overall, compensation structures provide better incentives to managers. Phenicia Seed Fund managed by ACP probably provides the best illustration. Net profits are distributed to investors first until they reach a 6% hurdle rate (in other words, investors are first paid back their contributed capital, then the share of the remaining profits allowing them to reach a 6% IRR). Then, fund managers are paid 25% of the amount allowing investors to get a 6% IRR. Finally, the reminder is split up between the investors and ACP managers, with 80% going to the former and 20% to the latter. Such structure is said to have disappearing preferential returns. As displayed in the scenario analysis below (Table 2.2), the fund managers need to deliver more than 6% IRR in order to get performance fees and more than c.8% IRR in order to have a share of 20% of the total capital gain after catching-up. Table 2.2 shows 3 scenarios (IRR of 3%, 6.5% and 15%) and their impact on the performance fees. For simplicity sake, all cash flows are supposed to flow out upon the liquidation of the fund and that the TND 10 million of investors' capital is fully paid-in up-front. The payoffs to investors and fund managers entailed by such structure are summarized in the payoff diagrams (Figure 2.7).

Table 2.2:

	Scenario	1	*Scenario 1: IRR = 3%*
			Scenario 2: IRR = 6.5%
			Scenario 3: IRR = 15%
	Capital Contribution	TND 10,000	
	Investment Period	10 Years	
	Hurdle Rate	6%	
	% of Hurdle Performance to Managers	25%	
	Managers' share in Reminder	20%	
	Fund's IRR	3.0%	

	Years	**0**	**10**
	Capital Contribution	TND 10,000	
	Fund's Final Cash Flow Assuming 3.0% IRR		TND 13,439
	Fund's Final Cash Flow Needed for a 6.0% Hurdle Rate		TND 17,908
	Capital Gain Corresponding to a 6.0% IRR		TND 7,908
1)	Share Redemption + Preferred Payment to Investors		TND 13,439
2)	Compensation to Managers for Reaching Hurdle Rate		-
	Reminder to be Split		-
3.1)	Investors' Share in Reminder		-
3.2)	Investors' Share in Reminder		-

Total Capital Gain	**TND 3,439**
Total Investors' Compensation	**TND 3,439**
Investors' Compensation as % of Capital Gain	*100.0%*
Total Managers' Compensation	**-**
Investors' Compensation as % of Capital Gain	*0.0%*

Scenario	2	*Scenario 1: IRR = 3%* *Scenario 2: IRR = 6.5%* *Scenario 3: IRR = 15%*

	Years	0	10
	Capital Contribution	TND 10,000	
	Fund's Final Cash Flow Assuming 6.5% IRR		TND 18,771
	Fund's Final Cash Flow Needed for a 6.0% Hurdle Rate		TND 17,908
	Capital Gain Corresponding to a 6.0% IRR		TND 7,908
1)	Share Redemption + Preferred Payment to Investors		TND 17,908
2)	Compensation to Managers for Reaching Hurdle Rate		TND 863
	Reminder to be Split		-
3.1)	Investors' Share in Reminder		-
3.2)	Investors' Share in Reminder		-

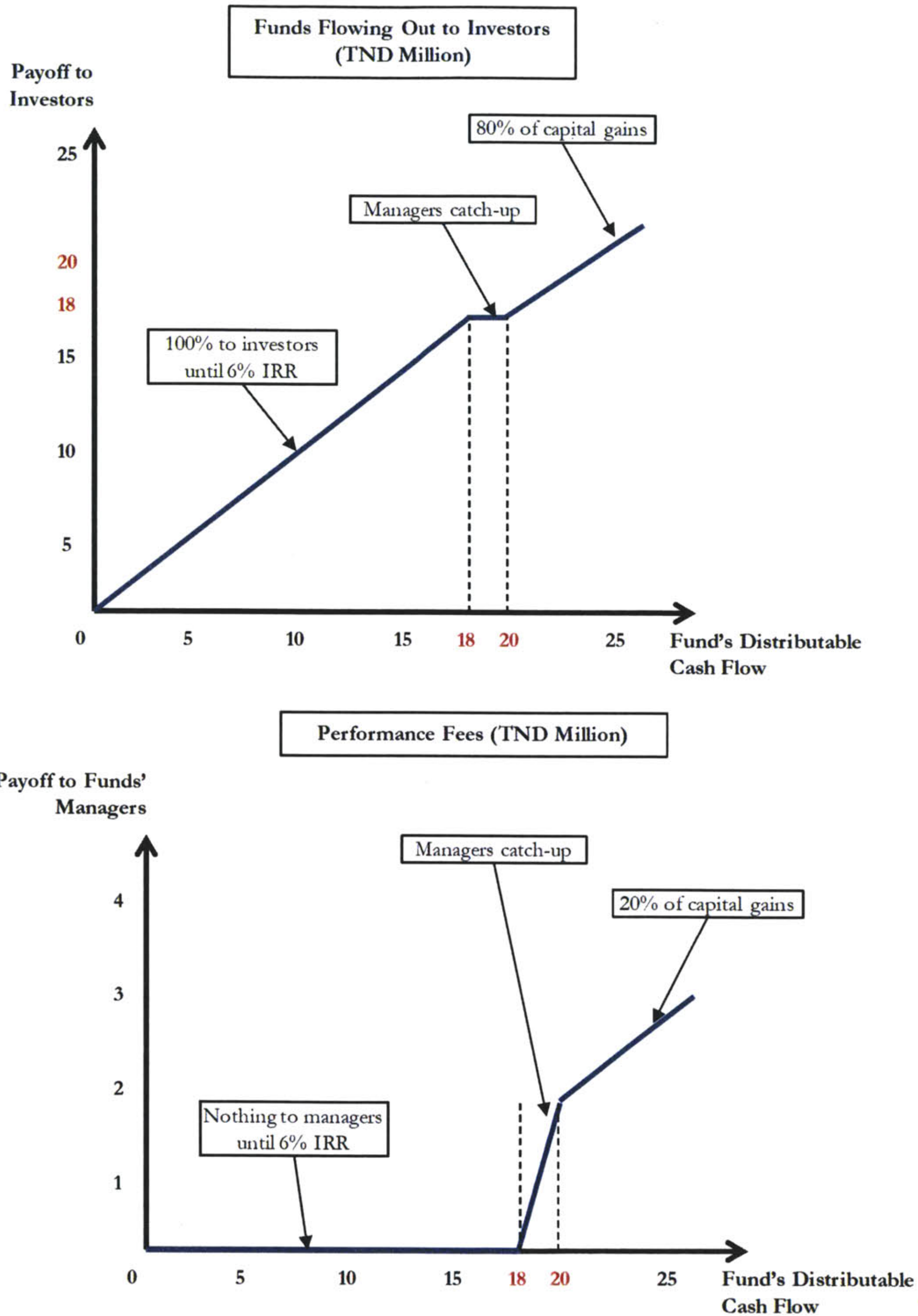
Total Capital Gain	**TND 8,771**
Total Investors' Compensation	**TND 7,908**
Investors' Compensation as % of Capital Gain	*90.2%*
Total Managers' Compensation	**TND 863**
Investors' Compensation as % of Capital Gain	*9.8%*

Scenario	3	*Scenario 1: IRR = 3%* *Scenario 2: IRR = 6.5%* *Scenario 3: IRR = 15%*

	Years	0	10
	Capital Contribution	TND 10,000	
	Fund's Final Cash Flow Assuming 15.0% IRR		TND 40,456
	Fund's Final Cash Flow Needed for a 6.0% Hurdle Rate		TND 17,908
	Capital Gain Corresponding to a 6.0% IRR		TND 7,908
1)	Share Redemption + Preferred Payment to Investors		TND 17,908
2)	Compensation to Managers for Reaching Hurdle Rate		TND 1,977
	Reminder to be Split		TND 20,570
3.1)	Investors' Share in Reminder		TND 16,456
3.2)	Investors' Share in Reminder		TND 4,114

Total Capital Gain	**TND 30,456**
Total Investors' Compensation	**TND 24,364**
Investors' Compensation as % of Capital Gain	*80.0%*
Total Managers' Compensation	**TND 6,091**
Investors' Compensation as % of Capital Gain	*20.0%*

Figure 2.7:



However, the analysis of the different funds in Table 2.1 also suggests that there are still several flaws in the system and that industry standards are not respected to some extent:

- Some funds are still launched at the initiative of a unique investor. For example, "ATID I" is an FCPR managed by ATID Co., a subsidiary of Al Baraka Bank (which promoted

the fund while being at the same time the deposit bank). Even though it is not clear whether other investors committed to the fund, the fact that the managing company is not independent hurts somehow the dynamics proper to a PE team.

- Except for Phenicia Seed Fund which clearly states that the funds committed will be called over time in 4 settlements of TND 2.5 million, other fund managers seem to have called the capital committed by investors upon the fund's formation. Therefore, during the first years of the fund's life, there is a mismatch between the cash available and the deal flow: managers have significant excess cash to handle while according to the industry standards, committed capital should be called as deal opportunities come up.

- A direct consequence of the precedent statement is that fund managers often become asset managers: as previously developed, it is not rare to see on the balance sheet investments in stock, bonds and mutual funds. The most extreme case is Fidelium Essor FCPR: as of 31-December-2010, about 70% of total assets were investments in the stock market.

- Performance fees are rarely as well structured as in the example of Phenicia Seed Fund. Most of them are structured around a hurdle rate, which is common in the industry. However, they often work against fund managers' interests for two main reasons. First, they do not include a catch-up provision (which makes managers able to "catch-up" their "lost" share of profits because of the preference provision put in place by investors, by capturing 100% of the cash flows until they reach the final target rate of net profits they contractually agreed upon). Second, some of them use hurdle rates which are far from the industry standard and do little to incentivize managers. For example, the managing company of FCPR Valeurs Developpement, Tunisie Valeurs, would get performance fees only if it reaches an IRR above 55% whereas the industry standard stands at 8%[24]. Finally, in some cases, the share of profits above the hurdle rate allocated to fund managers are well above the industry standard (20%), which plays against the investors' interests. This is the case for the Tunisian Development Fund managed by UGFS-NA where the managers would get 50% of the profits above a hurdle rate of 8%.

- Ultimately, most funds have no particular focus within the private equity spectrum. While ticket sizes are small across the entire spectrum (from USD 100k to USD 5.0m) compared to standards in developed markets, most of companies at least invest in VC and PE growth capital at the same time.

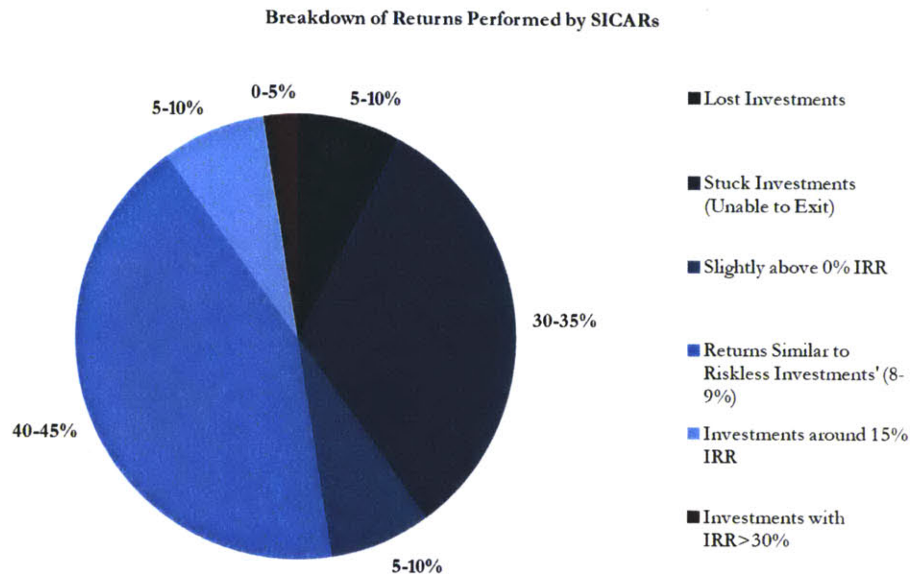
b) <u>Deal structures are flawed as most investments embed a carrying agreement</u>

Most investments made by SICARs and fund managers of FCPRs embed a "carrying agreement" feature. Such agreements are much more similar to debt than equity. More specifically, domestic PE funds contractually secure their investment by pre-agreeing with entrepreneurs upon fixed interest payments (the standard is 8-9%[25]) along with a pre-arranged retrocession schedule (fixing the timing and modalities under which the investment firm would retrocede shares to the entrepreneur(s)). Moreover, the fixed interest payments of 8-9% are not as riskless as fund managers would have expected since the share of lost investments and "stuck" investments (no exit possible due to the inability of the entrepreneur to redeem SICAR or FCPR's shares) is significant. There seems to be a mispricing of the risk embedded in such structures by the fund managers: while the upside is capped by the fixed interest payments and

[24] Andrew Metrick & Ayako Yasuda, "The Economics of Private Equity Funds"
[25] Research Report Nr. 35, Tunisie Valeurs, November 2006

the redemption of principal at its face value, the risk of getting stuck and not being able to exit is relatively high (cf. breakdown of SICARs' returns in Figure 2.8).

Figure 2.8:



Source: Tunisie Valeurs, Research Report Nr. 35, November 2006

The development of such a practice is mainly driven by the fact that SICARs are often an extension of the retail banking activity. According to a report published in the context of a seminar around private equity (organized in 2005)[26], at least 80% of the investments made by SICARs owned by financial and non-financial institutions in 2005 embedded a carrying agreement. Moreover, a significant share of investments made by SICARs owned by banks targets companies which are already customers of the retail banking segment: SICARs typically "lend" money to clients who cannot borrow enough from the typical retail banking channel due to a lack of tangible guarantees (even though they sometimes go to the point of pledging the investments made by SICARs with the entrepreneur's shares or intangible assets). Instead of helping portfolio companies grow through monitoring and advisory, fund managers often spend their time negotiating and enforcing the carrying agreements.

The recourse to carrying agreement also creates a negative dynamics in the industry: as long as such structures remain possible, fund managers who wish to invest in riskier securities (typically common equity) have a competitive disadvantage. Entrepreneurs are indeed often reluctant to open their capital and prefer fixed arrangements under which they are able to capture all the upside.

Another deleterious effect of carrying agreements is that they encourage entrepreneurs to be less transparence and misconduct in terms of corporate governance. As a matter of fact, since entrepreneurs need to pay interests and buy back the shares of PE funds according to a pre-arranged schedule, they become more likely to take the money from the company's treasury in order to do so.

[26] Pierre Hoessler, "Rapport Final de Mission", February-March 2005

This practice was not forbidden until recently (on the contrary, the law used to make pre-arrangements in view of retrocession mandatory). Yet, a law promulgated in January 2009 clearly stipulates that SICARs and FCPR fund managers can no longer pre-arrange with the initial shareholders of their portfolio companies any kind of payment uncorrelated to the company's results and performance. Even though the legislation regarding carrying agreements has recently evolved in the right direction, such contracts are allegedly still a common practice among domestic PE funds.

c) Funds' investors are mainly driven by fiscal incentives instead of deal returns

The way fiscal incentives are structured does little to "professionalize" the industry. It provides an additional incentive for investors to take less risk and hold on to the practice of carrying agreements: fiscal incentives tremendously boost the value of their investments. Consequently, a typical 9% IRR delivered by (allegedly) low-risk carrying agreements turns out to be enough. The Excel model displayed in Table 2.3 shows how fiscal incentives impact the IRR and the net present value of PE investments.

Table 2.3:

Fiscal Incentives for SICARs & FCPRs - Impact on IRR

Scenario	1

Scenario 1: min. 65% invested in the list, 35% of taxable income reinvested
Scenario 2: min. 65% invested in the list, 100% of taxable income reinvested
Scenario 3: min. 65% invested in the list, 20% of taxable income reinvested
Scenario 4: min. 65% invested in the list, 33.3% of taxable income reinvested
Scenario 5: min. 75% invested in underdeveloped regions, 100% of taxable income reinvested

Taxable Income	10,000
Investment Period	10 Years
Corporate Tax Rate	30%
Share of Taxable Income Invested in Year 0	35%
Minimum Tax Rate	20%
Pre-Arranged Fixed Interest Rates in SICAR Investments	9%
Cost of Capital	9%

Years	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Taxable Income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Investment in SICARs	(3,500)	-	-	-	-	-	-	-	-	-	-
Tax Expense if no Investment in SICARs	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
New Tax Expense	(2,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Fiscal Gain	1,000	-	-	-	-	-	-	-	-	-	-
Pre-Arranged Fixed Interest Payment	-	315	315	315	315	315	315	315	315	315	315
Principal Redemption	-	-	-	-	-	-	-	-	-	-	3,500
Cash Flows Available to Distribution	**(2,500)**	**315**	**315**	**315**	**315**	**315**	**315**	**315**	**315**	**315**	**3,815**
Discount Factor @ 9%	1.00	0.92	0.84	0.77	0.71	0.65	0.60	0.55	0.50	0.46	0.42
Discounted Cash Flows	**(2,500)**	**289**	**265**	**243**	**223**	**205**	**188**	**172**	**158**	**145**	**1,611**

IRR at the Investor Level	14.6%
Investment NPV	1,000

Optimal Level of Reinvestment if no 75% Investment in Underdeveloped Regions

% of Taxable Income Reinvested	**33.3%**
Investment in SICAR	3,333
Tax Expense without Minimum Constraint	(2,000)
Minimum Tax Expense	(2,000)

Scenario 2

Scenario 1: min. 65% invested in the list, 35% of taxable income reinvested
Scenario 2: min. 65% invested in the list, 100% of taxable income reinvested
Scenario 3: min. 65% invested in the list, 20% of taxable income reinvested
Scenario 4: min. 65% invested in the list, 33.3% of taxable income reinvested
Scenario 5: min. 75% invested in underdeveloped regions, 100% of taxable income reinvested

Years	0	1	2	3	4	5	6	7	8	9	10
Taxable Income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Investment in SICARs	(10,000)	-	-	-	-	-	-	-	-	-	-
Tax Expense if no Investment in SICARs	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
New Tax Expense	(2,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Fiscal Gain	1,000	-	-	-	-	-	-	-	-	-	-
Pre-Arranged Fixed Interest Payment	-	900	900	900	900	900	900	900	900	900	900
Principal Redemption	-	-	-	-	-	-	-	-	-	-	10,000
Cash Flows Available to Distribution	**(9,000)**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**10,900**
Discount Factor @ 9%	1.00	0.92	0.84	0.77	0.71	0.65	0.60	0.55	0.50	0.46	0.42
Discounted Cash Flows	**(9,000)**	**826**	**758**	**695**	**638**	**585**	**537**	**492**	**452**	**414**	**4,604**

IRR at the Investor Level	**10.7%**
Investment NPV	**1,000**

Scenario 3

Scenario 1: min. 65% invested in the list, 35% of taxable income reinvested
Scenario 2: min. 65% invested in the list, 100% of taxable income reinvested
Scenario 3: min. 65% invested in the list, 20% of taxable income reinvested
Scenario 4: min. 65% invested in the list, 33.3% of taxable income reinvested
Scenario 5: min. 75% invested in underdeveloped regions, 100% of taxable income reinvested

Years	0	1	2	3	4	5	6	7	8	9	10
Taxable Income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Investment in SICARs	(2,000)	-	-	-	-	-	-	-	-	-	-
Tax Expense if no Investment in SICARs	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
New Tax Expense	(2,400)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Fiscal Gain	600	-	-	-	-	-	-	-	-	-	-
Pre-Arranged Fixed Interest Payment	-	180	180	180	180	180	180	180	180	180	180
Principal Redemption	-	-	-	-	-	-	-	-	-	-	2,000
Cash Flows Available to Distribution	**(1,400)**	**180**	**180**	**180**	**180**	**180**	**180**	**180**	**180**	**180**	**2,180**
Discount Factor @ 9%	1.00	0.92	0.84	0.77	0.71	0.65	0.60	0.55	0.50	0.46	0.42
Discounted Cash Flows	**(1,400)**	**165**	**152**	**139**	**128**	**117**	**107**	**98**	**90**	**83**	**921**

IRR at the Investor Level	**15.0%**
Investment NPV	**600**

Scenario 4

Scenario 1: min. 65% invested in the list, 35% of taxable income reinvested
Scenario 2: min. 65% invested in the list, 100% of taxable income reinvested
Scenario 3: min. 65% invested in the list, 20% of taxable income reinvested
Scenario 4: min. 65% invested in the list, 33.3% of taxable income reinvested
Scenario 5: min. 75% invested in underdeveloped regions, 100% of taxable income reinvested

Years	0	1	2	3	4	5	6	7	8	9	10
Taxable Income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Investment in SICARs	(3,333)	-	-	-	-	-	-	-	-	-	-
Tax Expense if no Investment in SICARs	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
New Tax Expense	(2,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Fiscal Gain	1,000	-	-	-	-	-	-	-	-	-	-
Pre-Arranged Fixed Interest Payment	-	300	300	300	300	300	300	300	300	300	300
Principal Redemption	-	-	-	-	-	-	-	-	-	-	3,333
Cash Flows Available to Distribution	**(2,333)**	**300**	**300**	**300**	**300**	**300**	**300**	**300**	**300**	**300**	**3,633**
Discount Factor @ 9%	1.00	0.92	0.84	0.77	0.71	0.65	0.60	0.55	0.50	0.46	0.42
Discounted Cash Flows	**(2,333)**	**275**	**253**	**232**	**213**	**195**	**179**	**164**	**151**	**138**	**1,535**

IRR at the Investor Level	**15.0%**
Investment NPV	**1,000**

Scenario 5

Scenario 1: min. 65% invested in the list, 35% of taxable income reinvested
Scenario 2: min. 65% invested in the list, 100% of taxable income reinvested
Scenario 3: min. 65% invested in the list, 20% of taxable income reinvested
Scenario 4: min. 65% invested in the list, 33.3% of taxable income reinvested
Scenario 5: min. 75% invested in underdeveloped regions, 100% of taxable income reinvested

Years	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Taxable Income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Investment in SICARs	(10,000)	-	-	-	-	-	-	-	-	-	-
Tax Expense if no Investment in SICARs	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
New Tax Expense	-	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Fiscal Gain	3,000	-	-	-	-	-	-	-	-	-	-
Pre-Arranged Fixed Interest Payment	-	900	900	900	900	900	900	900	900	900	900
Principal Redemption	-	-	-	-	-	-	-	-	-	-	10,000
Cash Flows Available to Distribution	**(7,000)**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**900**	**10,900**
Discount Factor @ 9%	1.00	0.92	0.84	0.77	0.71	0.65	0.60	0.55	0.50	0.46	0.42
Discounted Cash Flows	**(7,000)**	**826**	**758**	**695**	**638**	**585**	**537**	**492**	**452**	**414**	**4,604**

IRR at the Investor Level	15.0%
Investment NPV	3,000

I assume that Company "A" generates a taxable income of 10,000 in year 0 and is subject to the corporate marginal tax rate of 30%. "A" invests x% of its taxable income in a PE investment vehicle "B" (SICAR or FCPR). The capital is locked-up in the fund for 10 years and available cash flows are streamed up to investors each year (assuming neither management nor performance fees for simplicity sake). I assume that "B" manages to invest the 10,000 contributed capital (in year 0) in deals based on carrying agreements yielding a fixed 9% per year. In order to estimate the present value of the different strategy, I assume a cost of capital of 9% (the carrying agreements are similar to debt; I – simplistically – assume in this case that they are valued at par).

The first four scenarios assume that "B" will invest at least 65% of the capital within the scope of the Investment Code. In this case, "A" can invest at utmost 35% of its taxable income in "B" and is subject to the minimum tax rate of 20%: this is Scenario 1. Under Scenario 1, the combined effect of the IRR generated by "B" and the fiscal gain provide a total IRR of 14.6% for "A". The net present value of the investment is equal to the fiscal gain generated in year 0 (under the "at par" assumption), i.e. 1,000.

In Scenario 2, I assume that "A" invests its total taxable income in "B". As the limit of the tax relief is set to 35% of the taxable income, the invested capital above the limit (i.e. 10,000-35%*10,000 = 6,500) does not capture the fiscal incentives. The total IRR is lower than in the first case and "only" equal to 10.7%. The net present value of the investment is again equal to the fiscal gain, i.e. 1,000.

In Scenario 3, I assume that "A" invests only 20% of its taxable income in "B". The IRR is equal to 15% (because the constraint of 20% minimum tax rate is not triggered) but the net present value is only equal to 600 because the fiscal gain is lower in this case ("A" does not take full advantage of the tax relief by investing a lower amount in "B").

In Scenario 4, I assume that "A" invests the optimal level of its taxable income in "B". The corresponding optimal investment rate (33.3%) is determined such as the tax expense under this rate equates the expense to be paid under the 20% minimum tax rate regime. Indeed, in the case where "A" invests over 33.3% of its taxable income and less than 35%, the fiscal gain/invested amount ratio becomes lower because of the 20% minimum tax rate constraint. The net present value in Scenario 4 is 1,000.

In Scenario 5, I assume that "B" invests at least 75% of the contributed capital in underdeveloped region. In this case, "A" is allowed to deduct the totality of its investment from its taxable income without any minimum tax expense constraint. By investing 100% of its total taxable income, "A" maximizes its NPV (equal to the fiscal gain, i.e. 30%*10,000 = 3,000) and delivers a 15% IRR.

In conclusion, even when assuming that fund managers do not provide an intrinsic IRR higher than the cost of capital, investing in a SICAR or an FCPR still have a great value in NPV terms due to the fiscal gain up-front. As one would have expected, contributing capital in a PE fund whose strategy is to invest at least 75% in underdeveloped regions provides the greatest value because investors are able to deduct the whole amount from their fiscal base. If the fund managers only invest a minimum of 65% in the list provided by the Investment Code and do not particularly target underdeveloped regions, investors are better off committing at least 33.3% of their taxable income in the fund. Investing less would imply a lower NPV because the fiscal gain is not maximal. Above the 33.3% threshold, the IRR would continuously decrease because amounts invested increase while fiscal gain does not. Therefore, investors' willingness to invest more capital based on NPV maximization will depend on how comfortable they are about the fund managers' ability to deliver an IRR (excluding fiscal impact) higher than the cost of capital.

d) Fiscal incentives preclude overwhelming investment constraints

Tunisian authorities have historically seen domestic PE funds as tools to strengthen growth in underdeveloped region and to target the development of certain sectors of the economy. In exchange, fiscal advantages are provided to investors having recourse to such tools. However, as authorities infringed on fund managers' freedom to invest wherever they see value, the expected results have not been delivered neither in terms of amount invested (only an aggregate amount of c. TND 1.0 billion has been invested since 1995) nor in terms of good practice.

Changes Recently Introduced by the Two Statutory Laws Promulgated in October 2011

The two statutory laws (Nr. 99 and 100) published in October 2011 should improve the overall regulatory environment for domestic funds.

First, they provide a more flexible framework as the investment constraints previously prevailing were significantly relaxed. The set of tolerated investments was extended (all sectors except real estate development, the housing market and to some extent the Tunisian stock market). Now domestic PE funds are allowed to invest in sectors which do not benefit from fiscal advantages. By lifting the restraining conditions on investments, this reform should help the deal flow increase.

Second, to those who are eligible, fiscal advantages are no longer provided up-front under the fund managers' commitment to respect the conditions underlying the fiscal advantages; henceforth, they will be provided once the investments are undertaken and proven. This change should entail a decrease in tax litigations and make fund managers think about their fund's strategy from the outset (whether it should be fiscal-driven or not).

Third, the investment period was increased (2-3 years from the date of capital contribution instead of 1-2 years). However, it still diverges from the PE industry standards and worsened by the fact that the practice of capital commitment/capital calls is not well developed. The revocation of this requirement would help managers be more selective in their deals and let them freely define the investment period with their investors (typically 4-6 years after the initial capital commitment).

Finally, the authorities repealed to a great extent the fiscal incentives at exit: capital gains are not tax-exempt anymore. If the holding period is less than 5 years the full amount of the tax on capital gains shall be paid (30% for corporations, 10% for individuals); there is a 50% rebate

otherwise. Such decision is controversial for two reasons. First, the fiscal incentive at exit creates the right inventive to invest "efficiently" in order to take advantage of the tax-exemption on capital gains (whereas fiscal incentives at entry stays attractive for projects with an NPV equal to 0). There is a good case to make that the decision to withdraw the tax-exemption on capital gains can desensitize investors to pour money into PE funds. Second, the differential of tax rates triggered by a threshold holding period of 5 years intends to encourage PE fund managers to increase their investment period. Such decision could make sense when authorities wish to decrease investments driven by short-term gains. However, PE investments are typically held for several years and PE fund managers decide to exit once they have created "enough" value and see an exit opportunity. A good exit window might appear before the 5-year holding period; in this case, the tax differential can prevent the fund managers from exiting and make them withhold the exit. Should an attractive exit opportunity do not come up again, the bias introduced by the tax differential could destroy value for investors.

B) Offshore Private Equity Funds

"Offshore funds" are the second type of PE funds in Tunisia. Their managers raise capital in a foreign currency (generally Euro or US dollar) and have a regional investment approach. Some of them invest in the whole African continent (Actis, Emerging Capital Partners or "ECP", Tuninvest-Africinvest), while others target the MENA region (Swicorp, North Africa Holding, Abraaj Capital) or more specifically North Africa (Abraaj Capital through Kantara Investments, Emergence North Africa Partners – currently in phase of fundraising –). Although development financial institutions ("DFIs") such as the IFC and the EIB play an important role as LPs, they also make some direct PE investments.

Using publicly available information, I count 30 deals from non-domestic PE funds to date. 20 of them have been sourced by Tuninvest-Africinvest's team, of which 16 were generated *via* its first offshore fund "Tuninvest International Ltd". I estimate that the total capital invested to date is approximately TND 240 million. Due to a lack of available information regarding deal values, I made some assumptions when necessary (for example, if the ticket size range of the investments is publicly available, I used the median of the range as a proxy for the deal value). Excluding Tuninvest-Africinvest's investments, the total capital invested to date goes down to TND 150 million. The implied average ticket size is TND 9 million (c. $6.5 million). It goes up to TND 16 million (c. $11.5 million) when Tuninvest-Africinvest's investments are excluded. Tuninvest-Africinvest's average ticket invested is smaller than other funds', especially for its first offshore fund "Tuninvest International Ltd" with an average ticket size of less than TND 1 million ($13.5 million, 15 investments).

Table 2.4:

Target Company	Fund Manager	Fund Owner	Ticket Size	Year	Status	Type	Stake	Deal Value	Sector
Societe d'Articles Hygieniques	ECP	ECP Africa Fund II PCC, ECP MENA Growth Fund LLC	\$5-30m	2008	Current	Growth	49%	NA	Consumer Goods (Hygienic Products)
Agromed	ECP	ECP MENA Growth Fund LLC	\$5-30m	2003	Exited	Growth	NA	NA	Agribusiness
Altea Packaging	Swicorp	Intaj Capital	\$10-15m	2006	Current	LMBO	NA	c. \$10m	Industrials (Packaging)
Poulina Group Holding	Actis	Canada Investment Fund for Africa	NA	2007	Current	IPO	NA	NA	Diversified
SACEM	North Africa Holding	NA	NA	2007	Current	Growth	0.51	51%*6 = TND 3m	Industrials (Electro-Mechanical)
Unimed	Abraaj	The Kantara Fund	EUR 5-15m	2011	Current	Growth	NA	NA	Pharmaceuticals
Opalia Pharma	Abraaj	The Kantara Fund	EUR 5-15m	2009	Current	Growth	NA	NA	Pharmaceuticals
Gallus	Abraaj	The Kantara Fund	EUR 5-15m	2009	Current	Growth	NA	NA	Agribusiness
Comar Health	IFC	NA	NA	2011	Current	Growth	NA	TND 10m	Healthcare
Fuba Printed Circuits	IFC	NA	NA	2008	Current	Growth	19%	NA	IT, Telecom & Electronics
Cogitel	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1998	Exited	Growth	NA	\$1.9m	Industrials (Packaging)
Fuchi-Ka	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1999	Current	Growth	NA	NA	Textile
Galion	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	2000	Exited	Buyout	NA	NA	Industrials (Plastic Containers)
Hydrosol Fondations	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1997	Current	Growth	NA	NA	Services (Soil Studies)
Interchem	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1996	Exited	VC	NA	NA	Pharmaceuticals (Veterinary)
Medis	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1996	Current	VC	NA	NA	Pharmaceuticals
Permaflex	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	NA	Current	Buyout	NA	NA	Consumer Goods (Bedding Products)
SOPAT	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1995	Exited	Growth	NA	NA	Agribusiness
SOTUPA	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1998	Current	Growth	NA	NA	Pharmaceuticals (Cotton & Bandages)
SOVIA	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1997	Exited	VC	NA	NA	Agribusiness
SPG	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	2000	Exited	Growth	NA	NA	IT, Telecom & Electronics
STI (Accor Hotels)	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	2001	Exited	Growth	NA	NA	Hotels/Leisure
Tecno Catering	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1999	Exited	Growth	NA	NA	Services (Catering)
Tunisie Factoring	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1998	Exited	VC	NA	NA	Financial Services
Tunisie Valeurs	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	1998	Exited	Growth	NA	NA	Financial Services
Vitalait	Tuninvest-Afrincinvest	Tuninvest International Ltd	\$0.9m*	2000	Exited	Growth	45%	NA	Agribusiness
MPC Prokim	Tuninvest-Afrincinvest	Maghreb Private Equity Fund I	EUR 1.8m	After 2000	Current	Growth	NA	NA	Industrials (Resin)
Medis	Tuninvest-Afrincinvest	Maghreb Private Equity Fund I	EUR 1.8m	1996	Current	VC	NA	NA	Pharmaceuticals
Altea Packaging	Tuninvest-Afrincinvest	Maghreb Private Equity Fund II	EUR 2-15m	2006	Current	Growth	31%	\$19.5m	Industrials (Packaging)
Cotugrain	Tuninvest-Afrincinvest	Maghreb Private Equity Fund II	EUR 2-15m	After 2006	Current	Growth	NA	NA	Agribusiness
Omniacom	Tuninvest-Afrincinvest	Maghreb Private Equity Fund II	EUR 2-15m	2008	Current	Growth	0.3	NA	IT, Telecom & Electronics
Vitalait	Tuninvest-Afrincinvest	Maghreb Private Equity Fund II	EUR 2-15m	2000	Exited	Growth	45%	NA	Agribusiness
Vitalait	Tuninvest-Afrincinvest	Afrincinvest Ltd I	EUR 0.75-3m	2000	Exited	Growth	45%	NA	Agribusiness

**Average Ticket Investment*

Source: Public information available on the funds' websites, press

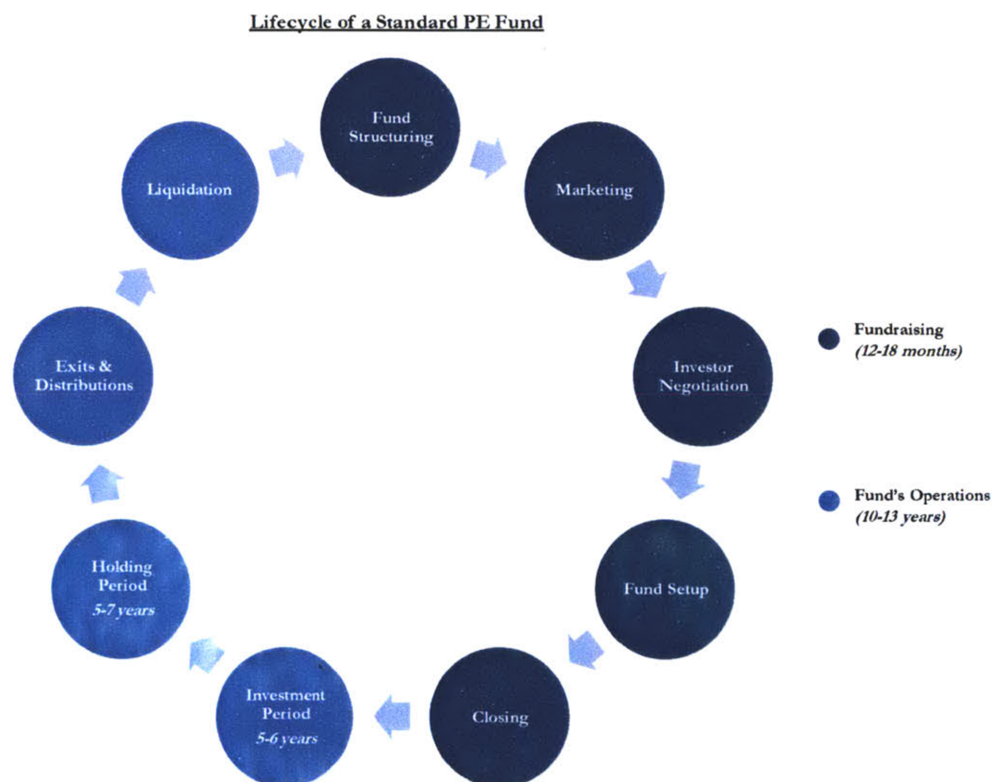
Most managing companies of offshore PE funds cited above have offices in Tunisia with local teams in charge of sourcing and managing PE deals in the country. Those fund managers represent the Tunisian community of PE professionals who meet private equity global standards. As opposed to domestic PE funds (SICARs and FCPRs), the typical GP-LP relationship and a real team dynamics are in place. Even though they target higher ticket sizes than domestic funds (between TND 5-20 million versus generally less than TND 1 million for domestic funds), the

bias introduced by fiscal incentives targeting domestic PE funds and the practice of carrying agreements infringes to some extent on the deal flow of offshore PE funds.

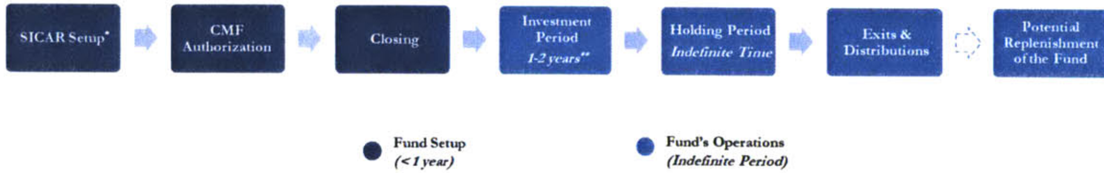
3) From Fundraising to Exit: The Private Equity Lifecycle in Tunisia

As discussed in the precedent part, the lifecycle of domestic PE funds is flawed from the outset mainly because the GP-LP relationship and their investment approach do not meet the industry standards. However, managers of offshore funds with a presence in Tunisia represent the "real" community of PE professionals in the country and have a great role to play in professionalizing the industry. That is why I will try to explain several features of the private equity lifecycle in Tunisia by focusing on offshore funds instead of domestic PE funds (see difference in lifecycle in Figure 2.9 below). More specifically, the analysis will cover the four main areas of the lifecycle: the fundraising phase, the investment period, the holding period and the exit of investments.

Figure 2.9:

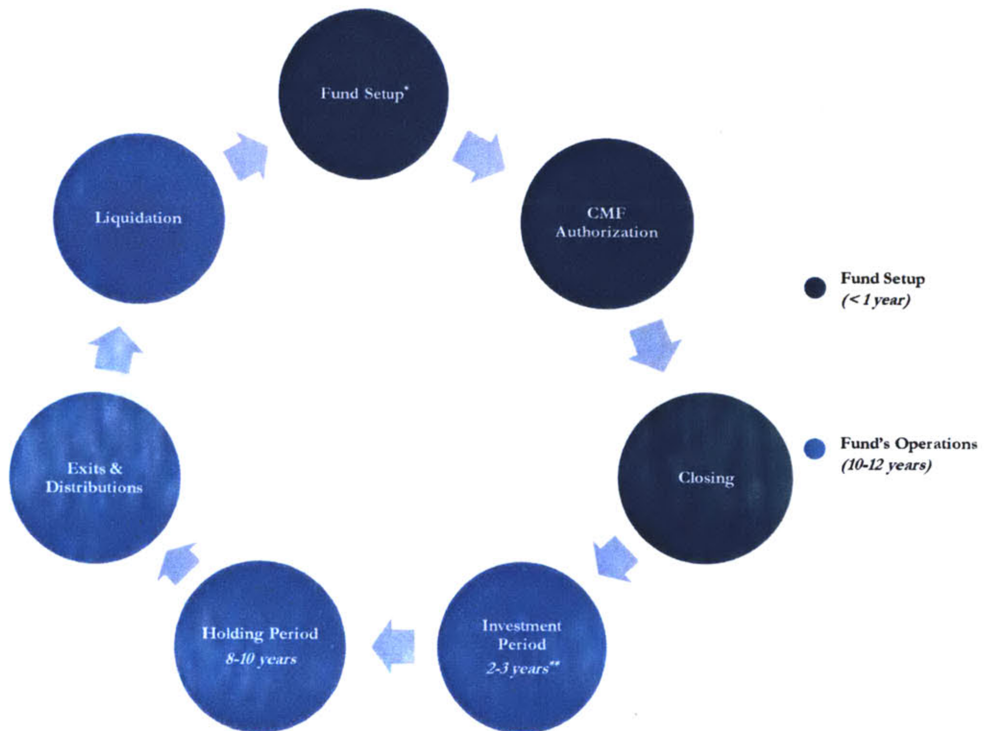


Lifecycle of a Typical SICAR



*Often tax-driven and at the initiative of one or several "LPs"
**Before the promulgation of statutory laws 99 &100 in October 2011. All capital subscribed should be called up-front

Lifecycle of a Typical FCPR



*Often tax-driven and at the initiative of one or several "LPs"
**Used to be 1-2 years before the promulgation of statutory laws 99 &100 on October 25, 2011. Usually all capital subscribed is called up-front

A Regional Perspective

Whereas domestic PE funds are typically set up at the initiative of one or several "LPs", managers of regional PE funds (with a presence in Tunisia) pitch global and regional institutions and try to persuade them to commit capital. The latter also often work with placement agents whose job is to find potential LPs.

Yet, fund managers agree that the rationale for raising funds from international and large LPs in order to target exclusively Tunisia is weak. The main issue is indeed the size and the scalability as certain macro indicators show (Table 2.5). The economy is small and potential to grow is limited as compared to other emerging market because of the limited size of addressable market as well as a less hot economy (slower growth rates). The direct consequence is that PE capital needed in Tunisia is limited (relatively to the size of commitments made by international LPs).

Table 2.5:

Macro Highlights on Tunisia

Total Population in 2010 (Million)	10.5 Million
Population CAGR 2005-2010 (%)	1.0%
GDP in 2010 (Current USD)	$44.3 Billion
GDP/Capita PPP in 2010 (Current USD)	$9,550
Real GDP CAGR 2005-2010 (%)	4.7%
Real GDP CAGR 2008-2010 (%)	3.4%

Source: World Bank, IMF

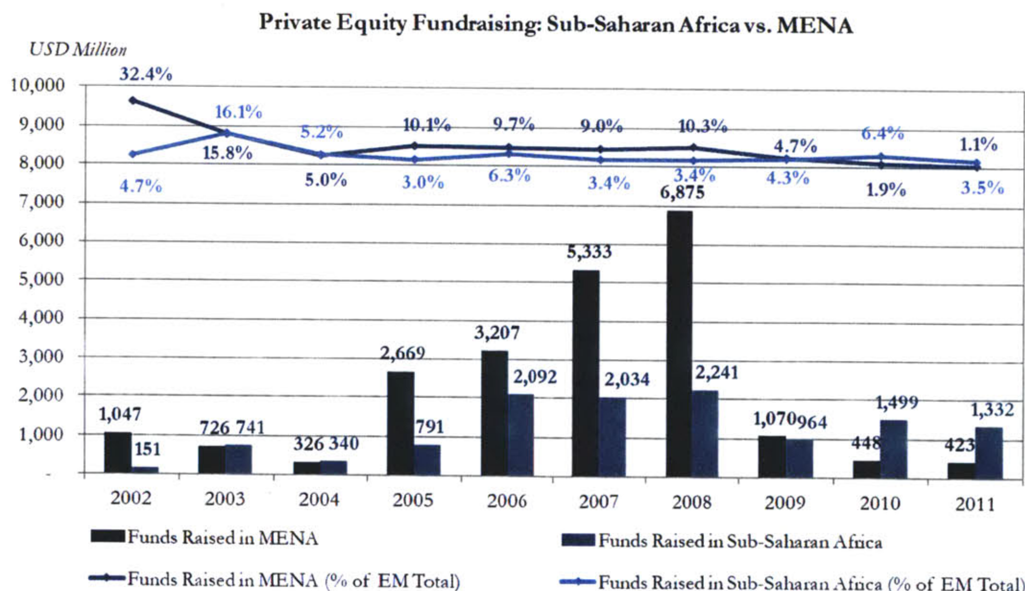
Moreover, for several reasons (to be developed later), fund managers looking for a certain range of ticket sizes (higher than the one sought by domestic PE fund managers) face some hurdles to generate deals. The combined effect of the small ticket sizes, the limited scalability of companies and the difficulty to generate deals, drives down the total "reasonable" size of a fund potentially focusing on Tunisia. In addition, LPs have a minimum commitment amount as part of their investment policy; a certain number of them (especially large public and private pension funds, and asset managers) would not be interested in committing capital. According to one of my interlocutors, a large pension fund such as the American Calpers would never accept to commit less than $10 million because they have some fixed transaction costs they need to cover. The rationale for raising an offshore fund focusing specifically on Tunisia is even more negatively impacted. Therefore, in all cases (except for Tuninvest's first offshore fund, Tuninvest International Ltd) Tunisia is typically part of a broader regional focus (Middle East & North Africa, North Africa, the Mediterranean area, the African continent). Therefore, it is essential to understand the dynamics of the "regional" fundraising since it has a direct impact on the activity of offshore funds in Tunisia.

Tunisia captures a (small) piece of offshore funds' investments focusing on two main areas: the MENA region and the African continent. At this stage, it is important to notice that funds

invested in "Africa" refer, most of the time, to funds invested in Sub-Saharan Africa. While Tunisia is not part of Sub-Saharan Africa, the development of private equity in this region has at least indirect impacts on the PE activity in Tunisia: some fund managers focusing more on Sub-Saharan Africa might be willing to access the North African market; there are already some pan-African funds (such as ECP, Actis, Tuninvest-Africinvest) who have investments in both North Africa and Sub-Saharan Africa; some funds can take advantage of the potential integration, complementarities and similarities between the two regions by expanding portfolio companies beyond their domestic market.

The MENA region and Sub-Saharan Africa are experiencing a different dynamics in fundraising activity. As displayed in Figure 2.10, fundraising in MENA boomed between 2005 and 2008 and represented on average 9.8% of the total yearly fundraising in the emerging markets. During this period, the fundraising level in MENA was well above the level in Sub-Saharan Africa (on average 4.0% of total fundraising in emerging markets during the same period). However, they both dropped at almost the same level in 2009 and the trend tremendously reversed in 2010-2011 with fund managers focusing on Sub-Saharan Africa raising approximately 3 times more capital than those focusing on MENA. Therefore, while Tunisia is usually considered as being part of North Africa and more largely the MENA region, the increasing PE activity in Sub-Saharan Africa which contrasts with a significant slowdown in MENA might relatively increase the importance of PE developments in Sub-Saharan Africa for Tunisia.

Figure 2.10:



Source: EMPEA

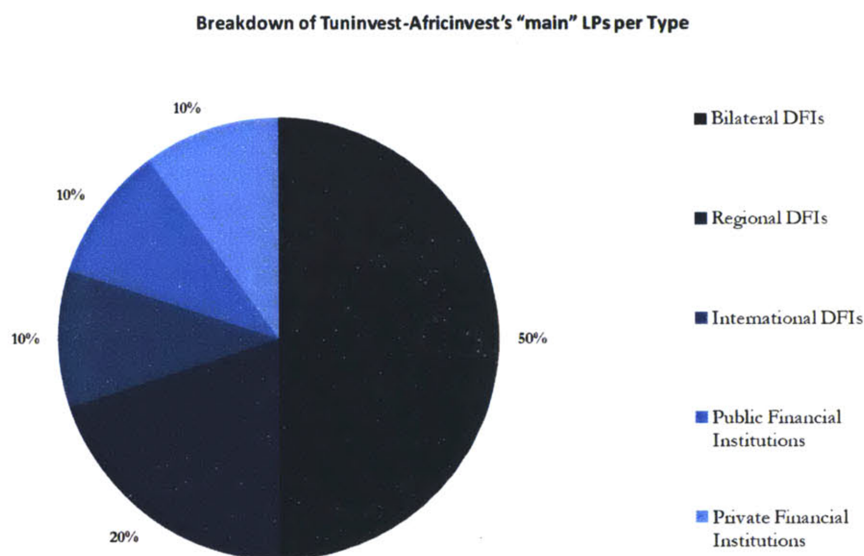
Tunisia as Part of the African Continent

DFIs play a very important role in developing private equity in Africa trough the capital they contribute as LPs. According to a research conducted by Preqin, 51 DFIs actively invest in private equity funds focusing on the African continent (9% of LPs investing in the region).

However, this statistics underestimates their role: several fund managers surveyed by Monitor suggest that the contribution of DFIs is above 50% of the total commitments in value[27].

The example of Tuninvest-Africinvest Group supports this consideration: as displayed in the diagram below (Figure 2.11), 8 out of its 10 "main" sponsors are DFIs. The most important source of funds for Tuninvest-Africinvest comes from bilateral DFIs, which represent a group of financial institutions set up by some European countries whose aim is to help private equity funds and financial institutions in emerging markets raise funds (example: Netherland's FMO, France's AFD, Belgium's BIO, Finland's Finnfund, Switzerland's SIFEM). Other DFIs are regional (African Development Bank, European Investment Bank) or multilateral (World Bank's IFC).

Figure 2.11:



Source: Tuninvest website

According to one of my interlocutors from Tuninvest-Africinvest, "PE firms in Africa only exist because of DFIs' willingness to develop "poor" countries". However, according to his experience, even though most of private investors do not look at the region (in the best case it is considered as a "frontier market"), more and more are now willing to take it into consideration and are asking PE fund managers to send documentation. While they first concentrated their African commitments on PE funds focused on South Africa (between 2008 and 2010, 57% of the total invested capital was captured by South Africa[28]), LPs are now more interested in the continent as a whole. As a matter of fact, in a survey conducted by Coller Capital in 2011, 44% of the global LPs interviewed said that they saw Africa as an attractive investment region while they were only 21% to say so in 2010. They seem in this regards to be more convinced by some "pitching" arguments since the crisis: the continent's economic health has a limited correlation with the rest of the world and shows great growth perspectives (c. 5% p.a.) when the developed world is facing recession, IRRs above 15% can be delivered without leverage (thanks to growth potential), people are more and more educated, the middle class population is expanding (good proxy for market size, especially for consumer goods). Even though cost of doing business is higher than in developed markets (inefficient infrastructure, difficulty to recruit talent, need for imports, etc.), fund managers notice that corruption and fraud are often well overstated.

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[27] Monitor, "Private Equity in the Shadow of Giants", 2011

[28] Jeune Afrique, Nr. 2649, 16-22 October 2011

LPs investing in the MENA region are mainly driven by three factors[29]: macroeconomic outlook, demographic change and portfolio diversification. As displayed by Table 2.6, the MENA region offers attractive macroeconomic and demographic fundamentals while allowing at the same LPs to be exposed to 12 politically and economically diverse countries with great integration potential.

Table 2.6:

Macroeconomic and Demographic Highlights on MENA

Number of Countries	12
GDP in 2010 (Current USD)	$1.4 Trillion
Expected GDP in 2015 (Current USD)	$2.3 Trillion
GDP Growth Rate in 2010E (%)	5.1%
Population below the Age of 30 (%)	57%
GDP per Capita in the GCC (Current USD)	$25,000
GDP per Capita in the Rest of MENA	$10,000

Source: PEI Research, "The Final Frontier: An Investor Perception Analysis of MENA Private Equity", November 2010

In MENA, fund managers have mainly sought to raise capital from domestic investors (e.g. family offices, big corporations) and governments (sovereign funds). While the boom of PE in the region in the early 2000s resulted in an unprecedented expansion of the number of funds, many of them blew up during the global financial crisis. According to one of my interlocutors at Swicorp, several reasons explain the vulnerability of those funds:

- Some of them have overpaid assets due to a competitive environment and a bubble in valuation levels, which generated significant losses once the bubble burst.

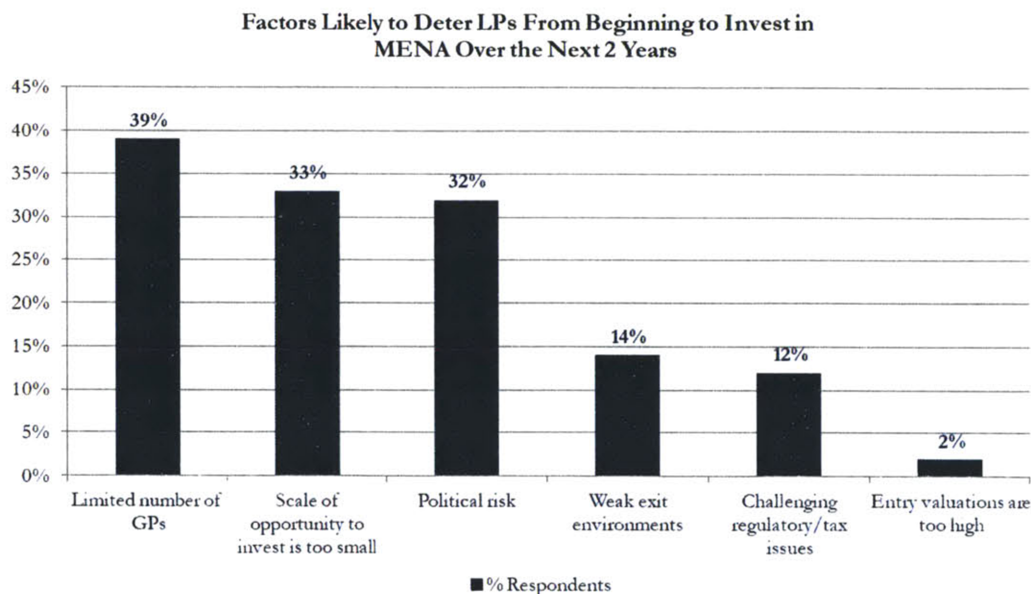
- Some fund managers did not manage to raise new capital for new funds because of a weak track record.

- LPs have become much less keen to (re-)invest; some of them have defaulted during the crisis. Liquidity is much more important for corporations and high net worth individuals: they are not as reliable as institutional investors and are often not keen to reinvest in future funds. In fact, most of them do not have a real investment strategy with clear allocations in the different asset classes.

- Some LPs did not honor their commitments and defaulted with their GPs because they lost money in 2008-2009. In developed markets, GPs would typically have gone to court as LPs breached a contractual agreement. However, this did not happen in MENA for three reasons: the legal framework is not sophisticated enough; it is not rare to have "close relationships" with investors; the fund managers do not want to tarnish their image among the community

While the region captured a significant share of the capital committed to EM PE fund managers prior to the crisis thanks to the huge amount of cash held by domestic investors, it is now considered as the "final frontier" in terms of commitments. Domestic investors are less keen (or capable) to pour capital into private equity in the region for the reasons stated above but also because they are now expanding their geographic scope (BRICs and Sub-Saharan Africa): it becomes even more important for fund managers in MENA to attract capital from international institutions. However, according to a survey conducted by PEI Media[29], the mean allocation for MENA as a percentage of total PE allocations (within the sample of LPs interviewed) was only 1.0% in 2010 and was expected to increase to 1.6% in 2012 (versus 3.2% in 2010 and 3.7% in 2012 for Sub-Saharan Africa). According to EMPEA (Figure 2.12), there are three important factors (more than 30% of the respondents) which would deter LPs from starting to invest in the MENA region over the next two years: the limited number of GPs, the limited scale of opportunities (relatively small amount of capital needed) and the political risk. It is worthwhile to note that the survey was conducted between December 2010 and January 2011 and might therefore underestimate the importance of political risk.

Figure 2.12:



Source: EMPEA

The survey conducted by PEI Research[29] also shows that track record is of utmost importance (the most important factor LPs would consider when evaluating MENA GPs according to the survey). We previously discussed that first-time funds in emerging markets performed quite well and that such data should ease the difficulty first-time fund managers are facing to raise money in a currently strained environment. According to Hassan Assad, Chief Investment Officer of the private equity and investment funds at the IFC, investments in MENA (which total 5.5% of IFC's PE allocation, i.e. $150 million) have performed well (around 20% IRR) with a significant share of first-time funds being successful[29]. However, paradoxically, according to the overall sample of LPs interviewed by PEI Research, doors for first-time fund

[29] PEI Research, "The Final Frontier: An Investor Perception Analysis of MENA Private Equity", November 2010

managers are expected to be closed in most cases and the standard of due diligence are expected to be very high. According to one of my interlocutors from Swicorp, one explanation of such skepticism among international LPs is the lack of good track record in the region. There have not been enough exits (and even less good exits since 2008) to convince LPs about the attractiveness of PE in the region.

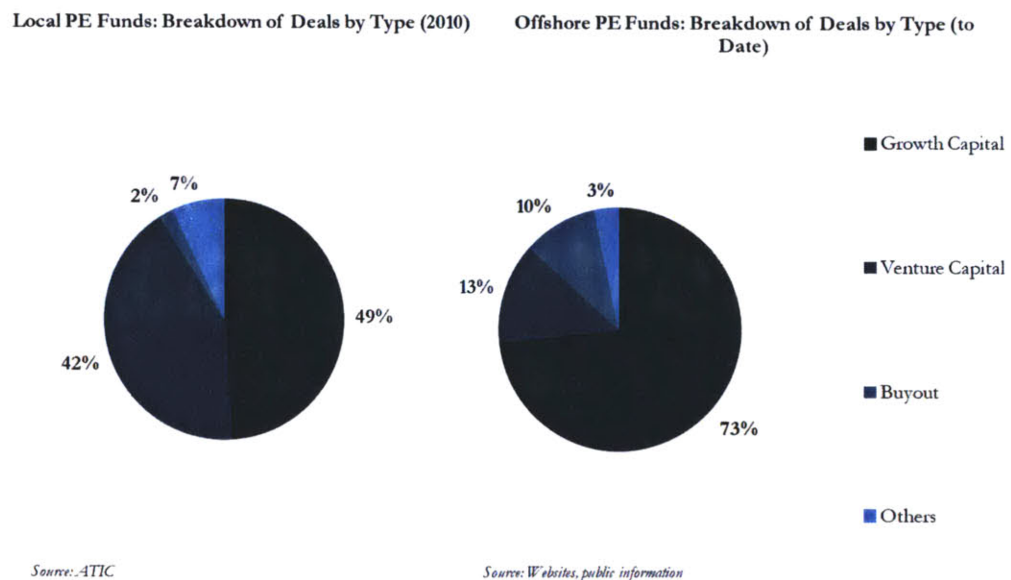
Within the MENA region, the share of North Africa excluding Egypt (Morocco, Algeria, Tunisia, and Libya) is small: most of investments are concentrated in the GCC countries and Egypt. According to EMPEA, of the $3.0 billion invested in the region, $2.2 (i.e. almost ¾ of the total investments) benefited only to Egypt and UAE. While Morocco captured $64m, offshore funds focusing on MENA have made very few investments in Tunisia.

B) The Investment Period

Investment Types

While venture capital represents a significant share of domestic PE funds' activity, growth capital constitutes by far the major portion of offshore funds' investments in Tunisia. As a matter of fact, based on the data provided by ATIC for domestic funds and the data I collected in Table 2.4 for offshore funds, 42% of domestic funds' transactions in 2010 were VC-type transactions while only 13% of offshore funds' transactions (to date) are considered as such – mainly Tuninvest's first international fund – (Figure 2.13). Growth capital, however, represents almost ¾ of offshore funds' transactions to date versus ½ for domestic PE funds in 2010. It is worthwhile to notice that domestic funds' share of growth capital investments increased over the past few years as funds raised and ticket sizes expanded; according to ATIC, growth capital represented only 40% of domestic funds' investments in 2008 versus 60% for venture capital. As previously discussed, the activity of SICARs and FCRPs in VC and growth capital often does not meet standards in developed markets.

Figure 2.13:



- **Early stage investment**

While there are significant opportunities in early stage investments, the ecosystem around entrepreneurship is still relatively weak. Offshore funds are generally not interested in VC-type transactions because they look for transactions with higher tickets and companies with a proven track record. Domestic VC funds often act like debtors in the sense that they require from the entrepreneur to buy back the injected capital according to a certain schedule. At the same time, they rarely play the role of VC investors: they often neither incentivize the entrepreneurs to develop their company and create value nor advise them on how to do so. As I previously developed, this is partly due to the fact that domestic fund managers have no experience in venture capital (or private equity in general) and cannot bring as much value as typical VC managers in developed markets would. There are some business angels who invest their own money along with entrepreneurs for very early-stage investments (seed investments). Such investments are generally plain vanilla equity and reflect more business angels' willingness to help entrepreneurs and promising projects rather than formal and sophisticated transaction processes.

However, a "premise" of an ecosystem around entrepreneurship and venture capital showed up recently. The first private incubator initiated by Mondher Khanfir in 2011, Wiki Startup, now provides entrepreneurs with a full range of services as per developed markets' standards: the incubator intends to help entrepreneurs accelerate the different stages of creation with advice covering ideas, business plans, fundraising and access to market. Not only the incubator can help entrepreneurs refine their ideas and host them, but it is also able to support them in defining a fundraising strategy and give them access to a network of potential investors. The business model can also be flexible as contracts can be structured around "success fees" instead of "fixed fees" when the amount becomes unbearable by the entrepreneur and the managers of the incubator see a strong potential in the project. In the same year, Maher Kallel launched the "Carthage Business Angels" association whose intend is to gather the community of Tunisian business angels and offer a platform whereby entrepreneurs can meet potential investors. It is also important to note that such structures not only share information about entrepreneurial projects but also cooperate in order to educate the community of entrepreneurs. According to a number of my interlocutors, it is fundamental to develop and reinforce the entrepreneurial culture among potential Tunisian entrepreneurs and investors. In this regards, events are organized by the different members of the ecosystem in order to attract, inform and educate both entrepreneurs and investors. For example, Wiki Startup, Carthage Business Angels and the Mediterranean School of Business successfully organized altogether an event around "Raising Funds from International Venture Capitalists" in December 2011. This type of events and symposiums is a strong tool to enrich and strengthen the entrepreneurial ecosystem. The event quoted above had two positive effects. First, it helped Tunisian entrepreneurs and venture capitalists to have a better understanding of the expectations and standards of international venture capitalists. Second, it provides a good example of how Tunisian entrepreneurship can be promoted and introduced to international investors.

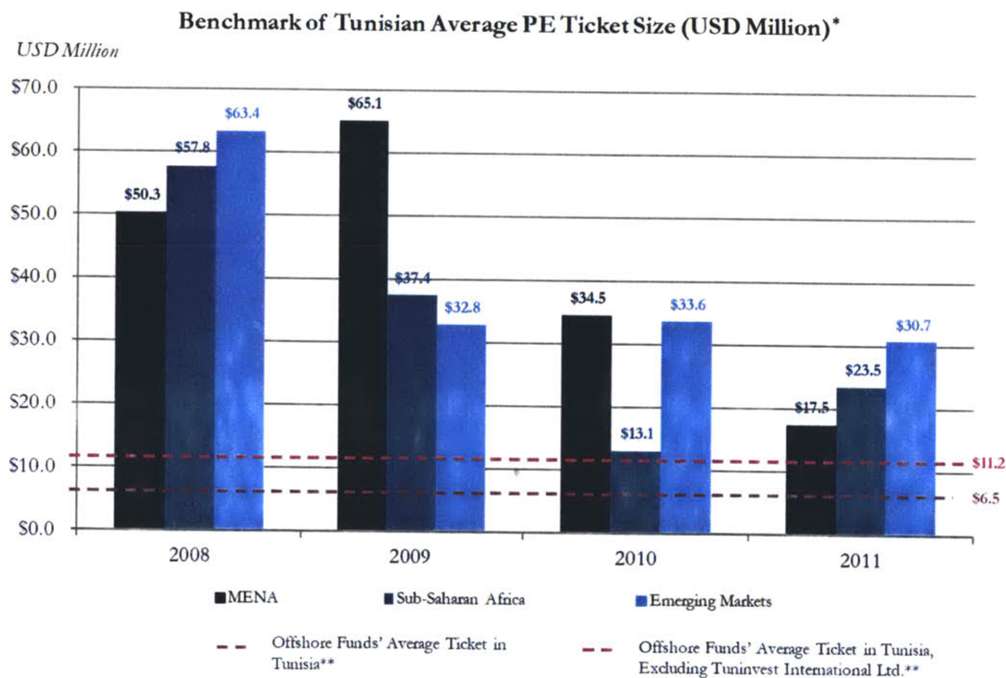
- **Growth capital**

Fund managers involved in growth capital private equity targets medium-sized company which needs capital to finance future growth. Growth capital constitutes the bulk of PE investments in emerging markets due to a combination of economic and demographic factors. The most important of them are reasonable demographic and GDP growths, low penetration rates in certain sectors, a strong increase in the middle-class and the GDP/Capita, a change in consumption habits, a potential expansion of local products and services *via* the replacement of

imports or the increase in exports. Investors consider that the risk-reward profile of such investments is attractive because the can generate attractive returns without any leverage.

The need for growth capital private equity is particularly relevant in Tunisia as 90% of total companies are SMEs[30]. However, the size of potential PE investments is limited because the companies typically look for small amount of capital (between $3-4 million). This is more what the PE jargon would call "small cap" investments rather than "mid-cap" investments. This size of investments corresponds more to VC-type financing in developed markets. Consequently, average ticket sizes of PE investments in Tunisia are unusually low. I derived the average ticket size of later-stage investments made by offshore funds in Tunisia (to date) based on the data gathered in Table 2.4 and some estimates I made. As displayed in Figure 2.14, it is equal to $6.5 million when I include Tuninvest's first international fund (Tuninvest International Ltd) and $11.2 million when I exclude it from the sample. I benchmarked this data to the average ticket size in MENA, Sub-Saharan Africa and emerging markets as a whole, and it appears indeed that PE tickets in Tunisia are well below the average elsewhere (the average ticket size over 2008-2011 is $42 million in MENA, $33 million in Sub-Saharan Africa and $40 million in emerging markets). The fact that ticket sizes are so small in Tunisia mirrors the difficulty that offshore funds face to source deals meeting their ticket size range (typically $10-20 million).

Figure 2.14:



*Excluding VC transactions. Tunisian ticket sizes are derived from my own estimates
** Transactions to date

Source: EMPEA, public information for offshore funds in Tunisia, proprietary estimates

Moreover, the small size of the Tunisian market (10.5 million inhabitants) and the relatively low GDP growth rate compared to other countries in the region constitute real limits in terms of scalability of consumer-oriented businesses. In order to generate attractive growth rates, fund

[30] IFC, "Union of Arab Banks Help Small Businesses in Maghreb Access Credit", Tunis, 5-April-2012

managers need to invest in considerably underpenetrated consumer good businesses. Other potential growth-type investments are businesses with a significant potential for exports or with a B2B business model.

According to one of my interlocutors from Swicorp, companies which have the potential to absorb higher ticket investments do exist but they generally do not see any advantage to open their capital to PE investors. First, those companies are generally owned by one or several families and are reluctant to the idea of giving up part of the ownership. Second, most of them have plenty of liquidity; they have enough internally generated cash flows and easy access to banks' financing in order to carry on investments. The only reason they usually see to open their capital structure is to bring in a strategic investor who can contribute a technological asset, a certain type of know-how or any kind of strategic partnership which adds value in business terms (e.g. Delice's shareholders which opened 50% of the company's capital to Danone in 1997).

- **Other types of investments**

Buyout transactions in Tunisia (and more generally in MENA and Africa) are rare for several reasons. First, a large number of companies are family-run businesses and shareholders do not wish to exit when the company is profitable. Moreover, top managers are often the founders themselves or have at least a close relationship with initial shareholders. As the market for management talents is limited and private equity investors consider that a good management is the most important criterion, most of the transactions are minority investments. Therefore, most companies left for buyouts are either in a distressed situation or are in a phase of intergenerational transition whereby the new generation of the family is willing to exit (the latter is rare though). Second, constraints on majority stakes for foreign investors (offshore funds are considered as so) and on domestic funds make it difficult to implement buyout transactions. Offshore fund managers need a special authorization from the Central Bank in order to buy a majority stake in a Tunisian company. Even when fund managers find a way to structure a buyout, it is very difficult to put some leverage and get acquisition financing. Banks are indeed used to require tangible assets as collateral. In addition, leveraged buyouts typically target mature companies with a very stable cash-flow profile, which is rare in the country. Finally, in some countries which provide a very attractive corporate taxation (example the UAE where there is no corporate tax), the rationale for leverage is weakened since there is no value creation through interest tax shields. Nevertheless, the latter statement does not stand for Tunisia since the marginal corporate tax rate is 30% (which offers potential incentives to raise debt in order to take advantage of interest tax shields).

Even though LBO-type transactions are very rare in Tunisia, it is not impossible to put a low level of leverage. Such transactions require an extra-effort from the fund managers (and potentially the CEO or CFO of the target company) in terms of negotiation and education of banks about this type of financing (e.g. Swicorp's investment in Altea Packaging). The level of debt would remain relatively low compared to the "mega" leveraged buyouts taking place in the US or in Europe. Typically, debt would represent 20-30% of the total capital structure or 1.5x EBITDA and would help optimize IRR and make companies more disciplined in order to cover interest payments and pay back the principal. For such levels of leverage, acquisition debt would typically cost TMM+1.5% (the TMM is the average monthly rate of money market fixed by the Central Bank). As the TMM is currently low (3.5% versus more than 5% prior to 2009), there is a window of cheap acquisition financing for LBO transactions should PE investors and managers be able to convince banks to lend. Nevertheless, fund managers need to carefully assess the risk related to this type of transactions and question whether it is an acceptable structure given the cash flow profile of the target company.

Distressed and turnaround investments are almost inexistent in Tunisia. The Investment Code used to encourage them through fiscal incentives (included in the list prior to the two statutory laws promulgated in October 2011) but the rationale for this type of investments is limited for three main reasons: current fund managers have little expertise in this area of private equity as it is very different from growth capital PE; the regulatory framework is not sophisticated enough to enable investments in distressed situations; distressed companies often suffer from a "bad" management and as previously developed, PE professionals give a great importance to the quality of the managers in place since it is difficult to replace them.

Finally, private equity funds could act as platforms for industry consolidation and asset swaps through "sell-off" transactions (also called "asset sales"). Some "large" holding companies or groups (e.g. Poulina Group Holding, Groupe Elloumi, Groupe Loukil, Groupe Bayahi, Groupe Kallel, etc.) often own assets in very diverse sectors. In this regards, private equity firms could play the role of platforms by buying similar businesses from holding companies willing to divest part of their assets. Acting as industry consolidators would enable PE fund managers to create value through potential synergies. They could also create a platform for asset swaps between the holding companies and participate indirectly to industry consolidation. They could indeed take advantage of the fact that such conglomerates see each others as "competitors" and rarely consider M&A transactions between themselves. However, such strategies are faced with two main hurdles. First, most families behind those holding companies are unwilling to streamline their business and focus on their core competencies rather than managing a "portfolio" of unrelated assets. Second, it is not an easy task to integrate entities used to different corporate cultures and management styles.

Sector Attractiveness

None of the offshore PE funds investing in Tunisia has a sector focus. Even though there is not enough data to derive a hierarchy of sectors, it is worthwhile to analyze offshore funds' investments in Tunisia per sector and compare the results to the current trends in the MENA region (Figure 2.15).

Investments in industrials and manufacturing (to date) are clearly preeminent in Tunisia (30% of the deals to date). It is also the case for the MENA region as a whole: the number of investments in this sector in 2009 and 2010 represent 19% of total investments. Investments in Tunisian companies playing in the industrials and manufacturing sector is mainly driven by the competitiveness of labor (relatively cheap and qualified), the existence of fast-growing and at least partly export-oriented companies, the capacity to reach a potentially large market (domestic and foreign consumers, "big" clients in B2B businesses), the expertise developed by a number of companies in their main line of business (e.g. packaging, plastic containers, electro-mechanical products, textile, hygienic products, etc.).

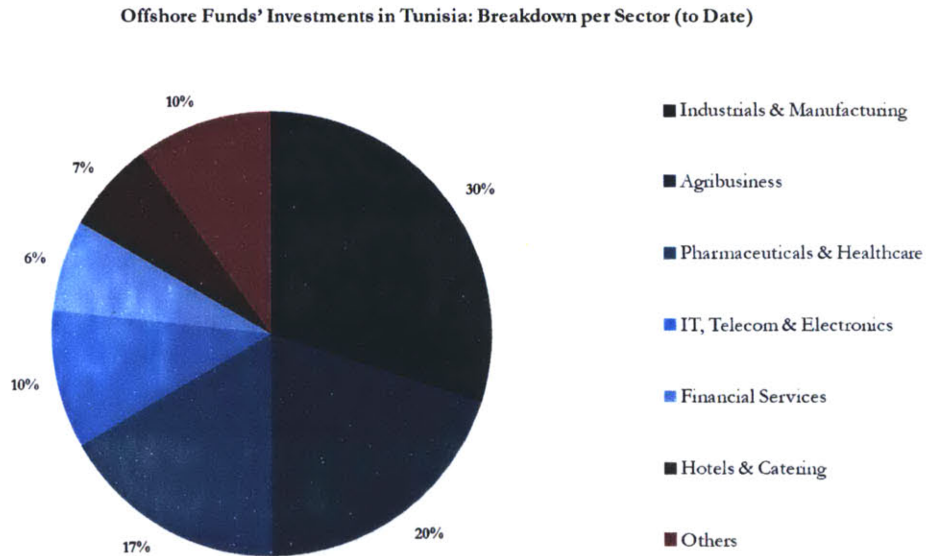
With 20% of PE investments in Tunisia to date, the agribusiness sector also offers great opportunities for growth equity. Tunisia is indeed famous for several high-quality products (olive oil, citrus fruits, dates, tuna, etc.) and there are plenty of opportunities to invest in the whole value chain of agribusiness: from exploitation to distribution, not to mention the full range of services gravitating around agribusiness (soil studies, fertilizers, supply chain optimization, etc.). The potential for growth is primarily driven by the proximity of important markets for exports (European Union, Middle-Eastern countries) as well as the room for modernization in agricultural practices. On the contrary, the agribusiness does not show up as one of the most important destination of PE capital in the MENA region as a whole. Arable land in GCC

countries (which capture most of PE deals) is indeed very poor (agriculture represents 0-4% of GDP versus over 10% for Tunisia). Yet, they are very rich in natural resources (notably oil and gas), which explains the high share of energy and natural resources in PE investments targeting the MENA region.

The partial liberalization of the pharmaceutical sector in 1989 entailed the emergence of many players and the rise of interest of international pharmaceutical companies in Tunisia. Even though the market is still controlled and regulated by the "PCT" (Pharmacie Centrale de Tunisie, a state agency), the sector has experienced strong growth reflected by an intensification in the production of generic drugs (40% of total production[31]) and the significant development of license agreements with large international pharmaceutical companies (Glaxo-Smithkline, Sanofi-Aventis, Merck, Astrazeneca, Pierre Fabre, etc.) under which Tunisian companies produce, market and sell (either domestically or for exports) products "owned" by these large international companies. The growth of this sector is mainly driven by the competitiveness of labor relatively cheap and highly skilled. Offshore PE funds showed interest in a number of valuable assets in the pharmaceutical sector with a strong potential for growth (e.g. Abraaj in Opalia Pharma, Unimed, Tuninvest in Medis, etc.).

There is also a real potential in the technology sector (mainly ITC, Telecom & Electronics) either for the domestic market (as a replacement for "imported" technologies) or for exports. Some PE investments such as the IFC in Fuba Printed Circuit, Tuninvest in SPG and Omniacom reflect the strong belief in the growth potential of Tunisian companies involved in this sector.

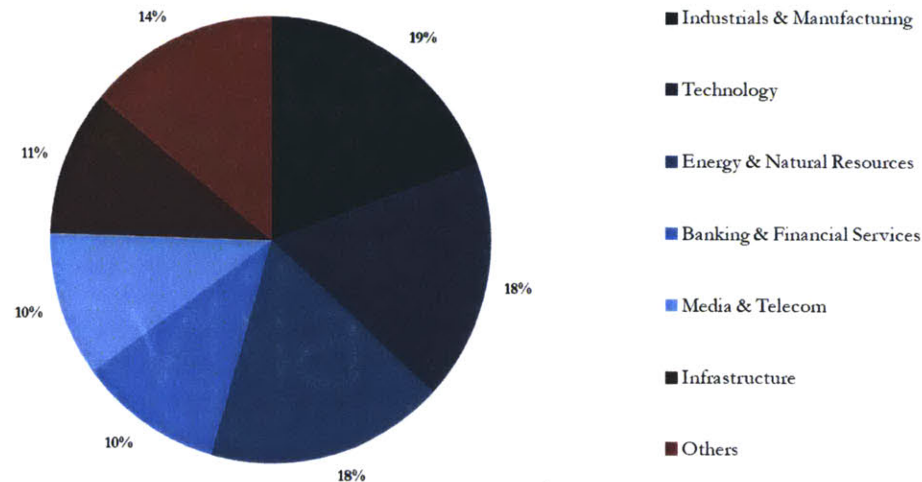
Figure 2.15:



Source: Public information, proprietary estimates

[31] Research Report, MAC SA, "La société ADWYA SA", Juin 2011

PE Investments in MENA: Breakdown per Sector (2009-2010)



Source: EMPEA

The absence of PE investments in infrastructure is appealing but it is mostly due to the fact that infrastructure is considered as another asset class. In more developed markets, funds investing in infrastructure have usually a specific focus on infrastructure because it is a different type of investment (the maturity is longer, the ticket size is generally higher, the risk/reward profile is different). However, there is a clear need to develop "hard" infrastructure (roads, highways, power, water, etc.) as well as "social" infrastructure (schools, hospitals, etc.) in inland areas. Public-private partnerships between the government and potential private funds investing in infrastructure could be a good way to develop investments in this area as it would bring an additional source of capital and a more efficient "private" management style. Moreover, infrastructure investments would have an indirect impact on growth capital PE as improved distribution channels and more generally a better equipped environment (notably in the inland areas) would improve even more the growth potential of Tunisian companies.

Several sectors are "protected" from foreign investments. As offshore funds have their capital denominated in a foreign currency, they are considered as foreign investors and are unable to invest in sectors such as distribution and real estate. They are also faced with more indirect issues related to sector protection. Foreign investors are for instance not allowed to possess agricultural lands while many factories are typically built on those lands.

Investment Criteria

Private equity fund managers mainly look at three criteria when they consider investing in a Tunisian company.

First, the management needs to be "good". "Good" does not necessarily mean world-class management but good enough to manage growth once the PE fund becomes a shareholder, understand their market, seize opportunities and manage crises. The CEO of a target company is typically the founder or a member of the founding family: the performance and the image of the company are often tight to the quality of his management. That is why PE funds often make minority investments and keep the management in place. Buyouts with a change of the

management team are riskier and difficult to implement (the market for talents is not large enough).

Second, the management also needs to be cooperative enough to work along with the fund managers in transforming the company. For example, many companies are not "clean" in terms of declaring employees to authorities, accounting and internal reporting; the management should be open to improve practices and corporate governance.

Third, fund managers seek companies which "do well" and have a strong business model but still provide some room for value creation. Typically, fund managers look into the competitive positioning and strategy of the company (business lines and products, market share, type of customers, providers, distribution channels, etc.), its cash flow profile (especially the way it generates revenues and its cost structure), and even more importantly the prospects for value creation either in terms of top-line growth (for example by selling new products, reaching new clients, expanding in other countries) or margin expansion (for example by optimizing the cost structure, reorganizing the business to increase efficiency).

Deal Sourcing Process

In order to generate deals, fund managers often need to look for potential targets themselves. There is generally no investment bank involved in the screening process as it can be the case in more developed markets. Fund managers are not actively "pitched" by investment banks to give them ideas of potential acquisitions. Most of the deals are generated on a proprietary basis and bidding processes are not the standard. According to my interlocutors, the main way to increase the deal flow is a "hands-on" approach. It is essential for fund managers to expand their network of key shareholders and CEOs in potential target companies. From a practical standpoint, they usually need to continuously meet and talk about potential opportunities with "businessmen" they know. In order to expand their set of potential targets, they also often need to go through national databases and seek for example companies with more than 50 employees; then, they try to meet with CEOs and/or key shareholders in order to educate them about potential "partnerships".

The education of companies' managers and shareholders is a key element of deal sourcing. It comes with active deal sourcing attempts. At the early stages of the relationship between the fund managers and the CEO/shareholders of the target company, it is often difficult to convince them about the rationale for partnering with a PE fund. As a matter of fact, companies' managers and shareholders often have a negative view on the constraints underlying PE funds' investments. First, private equity capital is much more expensive than a typical bank loan (cost of equity typically ranging from 15-30% versus 6-8% for a bank loan). Second, shareholders lose full ownership and control of the company while PE investors seek to protect themselves with negative covenants in shareholder agreements (especially in minority investments), which is culturally difficult to accept for family-run businesses. Third, PE professionals impose more costly but lawful practices when it is necessary (such as declaring all employees and avoiding fraud with tax authorities) as well as a "cleaner" accounting and a better internal reporting. More particularly, it is not rare to see negative shareholders' equity in companies' balance sheet because some managers (often owners) consider that the company's cash is their own money and therefore take out all the cash flows generated from the company's treasury for personal use. While an improvement in corporate governance and transparency is crucial for PE investors in the sense that it limits risks of fraud and potential downside risks at exit, companies' managers often consider the status quo as more convenient.

Moreover, companies' managers and shareholders rarely see the value added of PE investors: they often consider them only as a more expensive and much more constraining source of financing than banks. That is why it is more than crucial for fund managers to educate managers and shareholders about the basic rationale for PE investment. PE fund managers typically market their investments around the fact that they are not passive and "rigid" investors like banks. They require a higher return essentially because their equity investment is more at risk than banks' loans: they share the upside with the owners but also the downside. They are also active investors in order to make sure that their capital is efficiently put into work. Based on their past experience and expertise, PE fund managers usually support companies with strategic thinking, resource allocation, corporate governance and transparency, improvement of internal processes and capital structure optimization. However, it is not easy for companies' managers and shareholders to acknowledge these benefits; all fund managers agree that a good track record and especially success stories are essential. Concrete examples of successful partnerships in Tunisia would indeed make it easier for PE fund managers to market the rationale for private equity investments and would therefore improve the deal flow.

PE fund managers have noticed that CEOs and shareholders of potential target companies (more particularly "big" groups) have been more open to potential private equity investments since the Arab Spring; deals in the pipeline meeting their ticket size target have notably increased. This window opened mainly because companies have been fraught with several uncertainties:

- Uncertainty over the evolution of the political and social climate in Tunisia
- Uncertainty over growth prospects in the domestic market
- Uncertainty about banks' willingness to lend
- Uncertainty about the future of Algeria and the risks around instability in Libya
- Uncertainty about spillover effects of the European crisis and its impact on exports and/or potential write-offs due to unpaid products or services

Therefore, the value-added of collaborating with PE funds in this uncertain environment seems to make more sense from the target companies' perspective. PE fund managers could provide financial support whilst helping companies to operate a strategic shift and/or manage potential crises. Big groups also might be more willing to divest some of their uncorrelated businesses in order to get more liquidity in a context of cash-strapped environment.

Valuation

- **Valuation Levels**

PE professionals in the MENA region agree that valuation levels were overall excessive before 2008 and did not reflect the economic reality. Stephen Murphy, Managing Director at Citadel Capital, notes in this regard: "in 2007-08, valuation expectations [in the region] were excessive, driven by abundant liquidity and overly optimistic end-market expectations. We were uncomfortable with market conditions at the time, and did not invest. The global crisis, however, put an end to this market dynamic. Valuations are more reasonable and business owners have adjusted their expectations. We are now seeing more interesting investment opportunities."[32] However, the Arab spring does not seem to have uniformly brought valuations down and many PE players believe that valuation levels are still too high. As a matter of fact, Sherif Elkholy, Director at Actis, provides an interesting view: "The story of bargain hunting and doing deals at

[32] PricewaterhouseCoopers, "The Next Five Years, MENA PE", September 2011

very low prices at the time of crisis is theoretical. When cataclysmic events happen, the spread between buyers and sellers' price expectations actually gets wider. Take Egypt today for instance, vendors continue to think highly of their business and want to hold on to pre-revolution valuations. On the buyers' side, even if views on the growth of companies' earnings remained unchanged, equity risk premiums have changed. CDS spreads in the country have increased and ratings in the market are lower in terms of multiple. As a result, the gap between buyers and vendors' expectations has widened and a very limited number of deals will likely take place."[32]

In the region as a whole, fund managers have the sentiment that the Arab spring has not made valuation levels more in line with downside risks. However, in the case of Tunisia, companies' managers and shareholders seem to be more aware of the uncertainties and risks implied by the current instability according to my interlocutors. Deals in the pipeline have increased since summer 2011 as target companies not only see more rationale for partnering with PE funds but are also uncomfortable with the current "risk-on" environment. Such gap with the overall dynamics in the region can be explained by the fact that one of the main drivers of PE investments in Tunisia was the historically more stable political, regulatory and social environments as compared to other countries. Therefore, when combined to the increased demand for PE capital, the alteration of the "country" risk has naturally driven valuation levels down.

According to one of my interlocutors at Swicorp, EBITDA multiples for deals currently in the pipeline are around 5-6x in terms of EBITDA multiple and 8-10x in terms of P/E multiple as compared to 7-8x EBITDA multiple and 10-12x P/E multiple three years ago. Even before the Arab spring, the Tunisian market was viewed as being less expensive than other countries in the region. As a benchmark, Morocco is considered to be much more expensive; multiples in Morocco are manifestly higher: EBITDA multiples stand at 10-12x while P/E multiples are around 16-18x P/E (and can go up to 20-25x on certain deals, for instance in the insurance sector). This is driven by several factors: the high level of funds ready to be invested, the higher number of PE actors increasing competitiveness on deals, the higher share of bidding processes versus exclusive deals (target companies have more systematically recourse to investment banks), and a more developed stock market increasing the expected valuations at exit.

- **<u>Valuation Methods</u>**

PE fund managers have recourse to the usual valuation tools (discounted cash flows or "DCF", multiple-based approach, "VC" method).

- <u>Discounted cash flows:</u>
    - Future cash flows of the target company are forecasted within a certain time horizon and they are inflated at a perpetual growth rate starting from the final year of the forecasting period (typically the inflation rate)
    - The cash flows are discounted to their present value using the weighted average cost of capital ("WACC")
        - WACC = Cost of Equity * Equity Value/Enterprise Value + After-Tax Cost of Debt * Debt Value/Enterprise Value
        - Cost of Equity = Risk-Free Rate + Beta of the Company * Market Risk Premium (Capital asset pricing model, or "CAPM")
        - The risk-free rate is typically the rate of a long-term Tunisian treasury bond (c. 6%)
        - The equity market premium used is the premium of the stock market over the risk-free rate (6-8%)

        - The beta of the company is generally based on the average beta derived from a set of publicly traded comparable companies
    - However, there are several challenges encountered by PE professionals when using the DCF method:
        - Using the Tunisian treasury bonds as a risk-free rate is not accurate since it is not reasonable to consider such securities as "risk-free" (Tunisian treasury bonds are currently rated BBB-)
        - The market risk premium is biased by the inefficiency of the Tunisian stock market
        - The number of companies listed in the Tunisian stock market is very limited (only 59 listed companies) and some sectors are under-represented or not represented at all, which makes it difficult to derive reliable betas. Betas are consequently often drawn from "comparable" companies in foreign markets and might not reflect the systematic risk bared by a Tunisian target company
        - In some cases, the discount rate is adjusted for "country risk" but most of the time this approach is "fudgy"; it is more preferable to reflect such risks in projected cash flows from a conceptual standpoint (country risk is mostly idiosyncratic)

- <u>Multiple-based valuation:</u>
    - A multiple-based approach can either be based on traded comparable companies or comparable transaction multiples
    - Typically, PE professionals look for listed companies with a similar activity or comparable transactions in the same sector and derive multiples such as Enterprise Value/EBITDA, Enterprise Value/EBIT, price to earnings ratio (P/E), price to book ratio and other "accounting" multiples. Then, they apply such multiples to the corresponding accounting aggregate of the target company
    - There are also several challenges in this case:
        - The limited number of Tunisian companies listed in the stock market significantly reduces the set of comparable companies and looking for companies traded in foreign stock markets generally introduces a bias
        - There is little disclosure of transactions (especially for PE deals), which limits the use of comparable transactions
        - The multiples usually used often reflect the competitiveness in the deal market rather than a "fair" valuation

- <u>"VC" method:</u>
    - Cash Flows and "accounting aggregates" are forecasted over the expected holding period
    - A multiple-based approach is used to forecast the valuation upon exit
    - The exit value is "discounted to present" using a target IRR (typically 20-30%) in order to obtain the present value of the company (from the PE fund managers' perspective) and define the entry stake
    - This method is not exempt from multiple challenges:
        - The exit multiples are even more difficult to assess than entry multiples in the multiple-based valuation as more complexity is introduced by the evolution of the overall multiple levels and the industry cycles. It is not an easy to "market time"
        - Discount rates used are much higher than the equity cost of capital for three main reasons:

- Investments are illiquid and cannot be traded on the stock market (PE professionals often use a liquidity discount of 20-30%)
- PE professionals consider that they add value to portfolio companies and factor their service in the price as they spend a large amount of time monitoring portfolio companies and bring a reputation capital, access to skilled managers and industry contacts (but why not simply compensate them for their services?)
- PE fund managers discount idiosyncratic risk and optimistic cash flow forecasts (while it is more accurate to build uncertainty into the cash flow estimates)

Table 2.7 displays a simple Excel model illustrating the mechanics of the three valuation methods commonly used by PE professionals.

Table 2.7:

Valuation Methodology - Illustration

DCF Method

Cash Flow Calculation

Year	0	1	2	3	4	5	6	7	8	9	10	
Revenues	100	110	123	139	159	183	204	223	236	243	247	
% Growth		*10.0%*	*12.0%*	*13.0%*	*14.0%*	*15.0%*	*12.0%*	*9.0%*	*6.0%*	*3.0%*	*1.5%*	
EBITDA	40	46	54	64	76	91	102	111	118	122	123	
% Margin	*40.0%*	*42.0%*	*44.0%*	*46.0%*	*48.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	*50.0%*	
D&A	8	11	15	19	23	27	31	32	32	29	25	
% Capex	*20.0%*	*28.0%*	*36.0%*	*44.0%*	*52.0%*	*60.0%*	*68.0%*	*76.0%*	*84.0%*	*92.0%*	*100.0%*	
Operating Profit	32	35	39	45	53	64	72	79	86	93	99	
% Margin	*32.0%*	*31.6%*	*31.8%*	*32.4%*	*33.4%*	*35.0%*	*35.0%*	*35.6%*	*36.6%*	*38.0%*	*40.0%*	
Taxes	(10)	(10)	(12)	(14)	(16)	(19)	(21)	(24)	(26)	(28)	(30)	
% Tax	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	
EBIAT	22	24	27	32	37	45	50	55	60	65	69	
Capex	(40)	(41)	(42)	(43)	(44)	(46)	(45)	(42)	(38)	(32)	(25)	
As % of Revenues	*40.0%*	*37.0%*	*34.0%*	*31.0%*	*28.0%*	*25.0%*	*22.0%*	*19.0%*	*16.0%*	*13.0%*	*10.0%*	
Change in Working Capital	-	-	-	-	-	-	-	-	-	-	-	
Other Cash Adjustments	-	-	-	-	-	-	-	-	-	-	-	
Free Cash Flow	**(10)**	**(5)**	**1**	**7**	**16**	**26**	**36**	**45**	**54**	**62**	**69**	**699**
											1.5%	*Perpetual Growth Rate*

WACC Calculation

Risk-Free Rate	6.2%	*15-year Tunisian Treasury Bond*
Market Risk Premium	7.0%	
Beta	1.0	*Derived from a Set of Traded Comparable Companies*
Cost of Equity	**13.2%**	
Cost of Debt before Tax	7.0%	
Corporate Tax Rate	30.0%	
Cost of Debt after Tax	**4.9%**	
Target Equity Value/EV Ratio	80%	
Target Debt Value/EV Ratio	20%	
WACC	**11.5%**	

DCF Value

Year	0	1	2	3	4	5	6	7	8	9	10	Terminal Value
Gross Free Cash Flows		(5)	1	7	16	26	36	45	54	62	69	699
Discount Factor		0.90	0.80	0.72	0.65	0.58	0.52	0.47	0.42	0.37	0.34	0.34
Discounted Cash Flows		(4)	0	5	10	15	19	21	23	23	23	234
Enterprise Value	**370**											
Net Debt	74											
Equity Value	**296**											

Multiple-Based Approach

Comparable Companies EBITDA Multiple	7.0x
Company's EBITDA	40
Enterprise Value	**280**

VC Method

Holding Period	5 Years
Company's EBITDA in Year 5	91
Expected EBITDA Multiple at Exit	7.0x
Value at Exit	639
Target IRR	25%
Enterprise Value at Entry	**209**

- **Risk Assessment**

The Arab spring has brought more attention to the risk assessment of investment opportunities in the region. While risk assessment used to be more focused on the business risk, a survey conducted by PwC[32] shows that 53% of the GPs interviewed in the survey would give more importance to the assessment of political risk and would toughen the due diligence process before taking any investment decision. Theoretically, this kind of risk (for example the risk of expropriation or a sudden increase in tax rates) is most likely idiosyncratic and diversified away by well-diversified investors (namely the LPs). However, this does not mean that GPs should not care about political risks when they make investment decisions: they rather need to consider them as idiosyncratic risks and treat them as so in their valuation exercise. It is common to see investors add fudge factors in discount rates, which is often incorrect and introduces a bias[33]. Such risks need more careful judgment in cash flow projections even though estimating their impact is not an easy task because of their unpredictability and their non linear impacts. Another layer of complexity is added once we assume that investors are not necessarily rational. As a matter of fact, investors' increased focus on political risks since the Arab spring suggests that the availability heuristic might be at stake. As it is indeed difficult to estimate the impact of unpredictable political events on valuations, investors could tend to underestimate political risk when the environment observed is stable whereas they might be tempted to overestimate it once it materializes (e.g. the Arab spring).

The survey conducted by PwC also suggests that GPs in the MENA region will give more importance to macroeconomic risks such as inflation, currency depreciation and interest rate changes. GPs need to make a distinction between the idiosyncratic component (for example the risk of social movements following the Arab spring) and the systematic component (which reflects the correlation of the target company's performance to the overall economy) of the risk underlying their investments. While the former needs to be reflected in cash flow estimates, the latter is reflected in the cost of capital through the beta estimate. For example, let us assume that a Tunisian company "X" exports phosphate to big multinational clients. The revenue stream is secured by long-term contracts in USD. Such company would likely have a low beta: an economic recession in Tunisia should not affect its cash flow stream. However, social unrest and strikes would have a direct impact on its cash flows as they might prevent the company from honoring its contracts.

At the fund's level, currency moves can be an important concern. Offshore funds are denominated in "reserves" currencies such as USD and Euro. Therefore, currency moves can have a significant impact on the cash flowing to LPs; the difference between IRRs in domestic currency and IRRs in USD or Euro can be dramatic. For example, let us suppose that fund "A" denominated in Euro invests in a company "X" a certain amount in Tunisian Dinars. "A" would need to call Euro capital from its LPs and convert it in Tunisian Dinars. If the Tunisian balance of payments becomes under pressure due to a deterioration of the economic climate, the Central Bank might be forced to devalue the Tunisian Dinar. In such scenario, the final cash flows flowing to the fund would be worth less in Euro amounts and the IRR in Euro would be lower than the IRR in Tunisian Dinars due to the currency exposure. Whenever there is a timing gap between inflows and outflows, the fund's capital is subject to a currency exposure (another scenario for example is the time difference between the date at which fund managers seal a deal in Tunisian Dinars and the date at which they call the capital in Euro to make the payment). In such context, currency hedging is relevant but there are two main hurdles. First, the cash flows

[33] Brealey, Myers, and Allen, "Principles of Corporate Finance"

(drawdowns as well as distributions) are uncertain both in terms of size and timing[34], which makes a currency strategy at the fund level useless. However, fund managers have more visibility on cash flows generated by their portfolio companies and currency strategies might be implemented at this level. However, hedging tools are often very limited in emerging markets (particularly in Tunisia) and priced expensively. Fund managers consequently accept to be exposed to currency moves and commonly take speculative positions. They might factor in such uncertainty in their USD or Euro cash flow predictions but such exercise needs a lot of judgment call about macroeconomic prospects and is often difficult to implement during the negotiations with target companies about the valuation. Raising money from domestic investors would help GPs to cancel out currency exposure but there are many disadvantages and constraints in raising TND-denominated funds as previously discussed.

Deal Structures, Negotiation and Execution

Since most transactions are minority investments, PE fund managers seek to get some protections partly offsetting their lack of control. In developed markets, they typically use customized financial instruments and put in place several covenants in the shareholder agreement in order to do so.

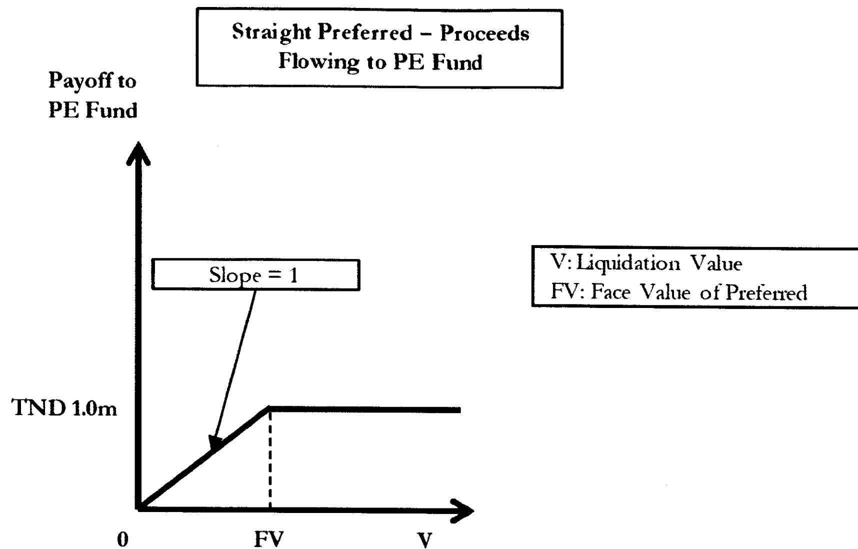
- **Financial Instruments Used in Deal Structures**

In order to protect themselves from a "take-the-money-and-run" scenario whereby selling shareholders would pull out the money before creating any value or sell too early, PE fund managers (especially those investing in relatively early stage company) typically need to protect themselves by creating shares with an embedded liquidation preference. There are several instruments used in the world of "sophisticated" VC and PE fund managers. The most important of them are detailed below.

- Redeemable preferred (or straight preferred) embed a mandatory redemption right which allows the investors to force liquidity event and prevent a "life-style company". It also specifies when it must be redeemed. When the company cannot redeem at the pre-agreed price, penalties can kick in (for example increased board seats). Dividends on those shares accrue and are typically paid upon redemption. Should the company be liquidated at a value lower than the face value, the investors would capture 100% of the final cash flows. However, they are not convertible into common stock. Figure 2.16 displays the payoff of a TND 1.0 million straight preferred.

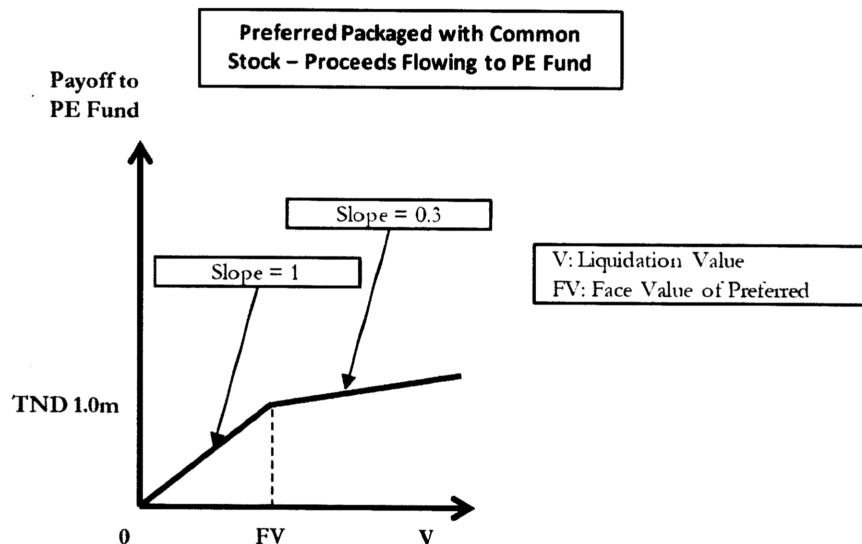
[34] Peter Cornelius, "International Investments in Private Equity"

Figure 2.16:



- More commonly, VC and PE investors have recourse to preferred shares packaged with common stock. Such instruments provide a downside protection for investors but also an upside potential. Once the fair value of the company surpasses the face value of the preferred share, investors would be entitled to get x% of the company in common stock. Figure 2.17 displays the payoff of a TND 1.0 million preferred packaged with 30% of common stock.

Figure 2.17:

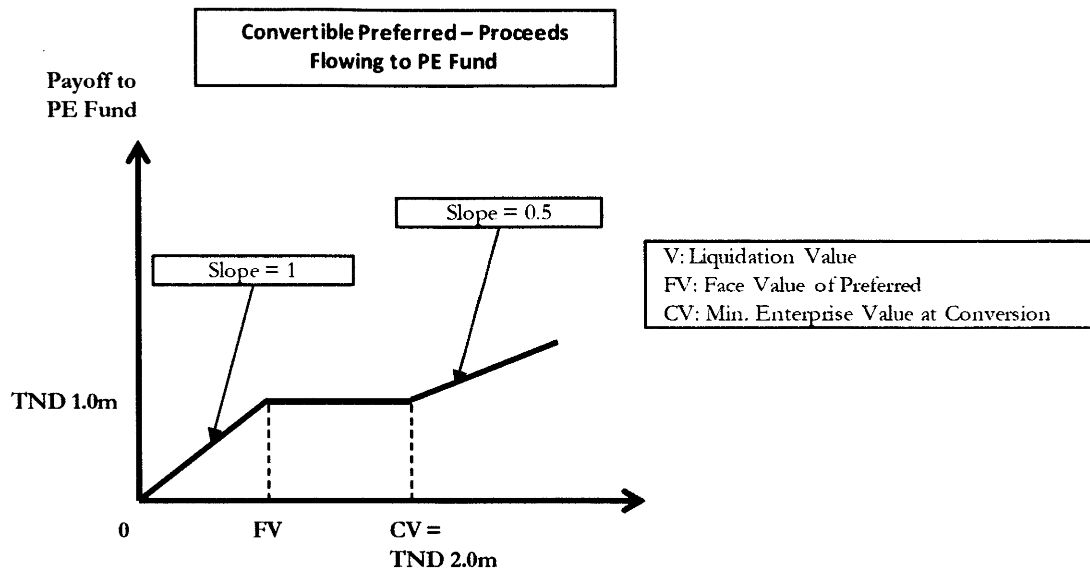


- Convertible preferred shares are the most commonly used instruments by venture capitalists[35]. They can be converted at the shareholders' option into common stock at a pre-specified conversion price. They typically convert if the total value obtained upon the liquidation event is greater than the liquidation preference with accrued dividends. There

[35] Yaron Leitner, "Convertible Securities and Venture Capital Finance", 2009

is also often an automatic conversion upon liquidation provided the proceeds are high enough. For example, if the initial investment is TND 1.0 million and the conversion price is TND 10 per share, the convertible preferred can be converted into 100,000 common shares. Assuming there are initially 100,000 shares, the PE fund would own 50% of the common shares and the conversion would kick in if the value of the company upon liquidation is greater than TND 1.0m/50% = TND 2.0 million (ignoring accrued dividends). Figure 2.18 displays the mechanics of this example.

Figure 2.18:



- PE investors can also have recourse to participating convertible preferred, that is to say convertible preferred with an extra feature: "in the event of liquidation or sale" (that is to say not an IPO), the holder gets the face value and an equity participation. In the case of a liquidation or private sale, this instrument has the same features as a preferred packaged with common stock whereas it has the same characteristics as a convertible preferred in the case of an IPO.

The role of preferred shares is fundamental in PE and VC investments as they align incentives of existing shareholders, the managers in the company and fund managers to strive for large payoffs whilst protecting PE or VC investors in the case of a downside scenario. The instruments used will largely depend on the negotiation process and the willingness of investors to incentivize existing shareholders and managers.

The Tunisian regulatory framework allows only a limited recourse to the financial instruments discussed. PE investors typically use plain vanilla equity and to some extent convertible instruments as regulators do allow the recourse to convertible debt. Convertible debt is very similar to convertible preferred. There are some differences though: convertible preferred is commonly treated as equity from an accounting perspective, it may be a perpetual security, and the company is not under any legal obligation to pay dividends on preferred stock. Even though the absence of convertible preferred can be replaced by convertible debt, the main hurdle is the limit of 30% of the total capital set by the regulators. Offshore funds can also be challenged by the Central Bank in converting their convertible debt in case they increase their ownership above the threshold of 50% (the investors would need to get a special authorization from the Central

Bank). Regulators do authorize preferred dividend stock but such instruments are also limited to 30% of the total capital, do not entitle their owners to any voting right and more importantly do not provide any liquidation preference.

PE professionals agree that the regulatory framework needs to become more flexible and provide more freedom to investors in structuring deals. The main underlying issue is that the current regulatory framework in place is based on the equality of rights embedded by shares: it does not allow any differentiation among shares as share class differentiation is not authorized. Tunisia has in this regard a competitive disadvantage when compared to other countries such as Morocco or many countries in Sub-Saharan Africa where investors have the freedom to structure deals as they wish. While "anything not forbidden by law is allowed" in those countries, "anything not explicitly allowed by law is forbidden" in Tunisia. However, according to some of my interlocutors, PE professionals are trying to lobby in order to make things change (notably through the association of PE professionals, the ATIC). Should the regulatory framework evolve, there would also be a need to educate companies' shareholders and managers about the benefits provided by those instruments (it is already difficult to generate investments in plain vanilla equity).

- **Contractual Protections and Negotiations**

PE and VC fund managers typically negotiate with the target company's shareholders a number of contractual clauses in order to protect themselves. The most important clauses are detailed below.

- Representations and warranties: a series of statements in the acquisition contract confirming several facts on the target company. They typically state the following: the target has no liabilities not shown on its balance sheet, financial statements are accurate, assets are in good condition, the target has committed no violations of law or governmental regulation, etc.

- Anti-dilution provisions: such provisions intend to protect the PE or VC fund from "down" rounds of financing whereby the target would raise additional equity funding at a price below the price negotiated by the fund managers. The conversion price of the fund's convertible preferred shares is lowered either to the price of the new financing ("full-ratchet anti-dilution") or based on a weighted average calculation (proportional price and equity protection, "weighted average anti-dilution").

- Right of first refusal: the PE or VC fund has priority over third parties if existing shareholders want to exit. In other words, if the existing shareholders find a potential buyer, they need to propose the same transaction to the PE fund; they would be able to sell to the third party only if the PE fund representatives do not exercise their right of first refusal.

- Preemptive rights: give the right to PE or VC investors to buy new shares offered by the target company in later financing rounds.

- Board representation: PE or VC investors require board seats (typically one or two in a board of 5 directors).

- Protective provisions (class voting rights): the approval of preferred shareholders is required for several decisions. Examples of such decisions are: the sale, merger or

liquidation of the company, changes in corporate charters, major acquisitions or budget changes, appointment or termination of a CEO. Such provisions allow investors to prevent any action by the management that would materially change the business risk of the company.

- Performance contingencies: such clauses tie the valuation of the target company to performance. Some aspects of the contract and/or the valuation are contingent on financial and non-financial performance measures. Examples of performance contingencies are: additional funding or share vesting conditional on completing a new benchmark, more voting control to the fund representatives if the EBIT is below a certain threshold, earn-out structure (the seller receives additional compensation if some financial goals are achieved)

- Tag-along or co-sale rights: if an offer is made for one of the shareholders' shares, that offer must be extended to other shareholders (namely the PE or VC investors). This situation is especially important in the case one of the founders exits as tag-along rights allow investors to exit at the same time and price.

- Drag-along rights: right to force shareholders to sell the company upon board and majority shareholder approval. Those rights intend to protect a majority block of shareholders from minority shareholders if an opportunity occurs (whereby the new buyer would typically ask for 100% of the total shares).

Offshore funds also use the typical clauses above when they invest along with Tunisian companies but some adjustments need to be made. The most important difference is the impossibility to create a different class of shares (in this case convertible preferred). Such difference has two main implications. First, anti-dilution provisions need to be negotiated on the basis of common equity rather than the conversion price of preferred stock. Second, as the companies are not authorized to issue shares with preferential voting rights, protective provisions cannot be implemented as they are in typical term sheets (that is to say giving veto rights to preferred shareholders). Yet, this restriction can be circumvented as it is possible to give veto rights for certain shareholders on well-defined and specific matters (business plan approval, external growth decision, agreements with related parties, appointment or termination of a CEO, etc.).

An arbitration clause is also often added to PE deals in Tunisia: PE professionals estimate that Tunisian judges are not familiar enough with PE term sheets or M&A agreements in general and would like to avoid "bad" decisions due to a misunderstanding of agreements in case of litigation. That is why they prefer courts of arbitration over Tunisian courts. In this case, private judges would make the decision and a Tunisian court would (easily) execute it. However, PE fund managers go very little to courts and prefer compromises not to ruin their reputation and image (which would negatively impact their ability to generate deals in the future). The term sheet (or shareholder agreement) provides some level of protection to PE investors in the sense that it serves as a basis for negotiation in case of litigation.

More importantly, the main hurdle encountered by offshore fund managers in Tunisia is the difficulty they have to explain and negotiate such clauses. Most of the target companies are family-run businesses (first to second generation of owners) not very familiar with "sophisticated finance" (managers typically see their bankers as the unique financing option) and M&A transactions. According to my interlocutors, pushing them to open their capital structure is already a very difficult task. Many deals would fall apart at the negotiation stage because the

sellers are often not willing to make concessions on the different clauses (right of first refusal, preemptive rights, tag-along, drag-along, veto rights, performance contingencies, etc.) while being "poorly" advised by lawyers not familiar with PE and M&A transactions. It often takes time for sellers to see that such contractual agreements are the norm and are necessary to seal a deal. While closing transactions is of course preferable, "failed" transactions at least contribute to educating shareholders and managers about deal making with PE funds.

- **Deal Execution**

According to PE professionals investing in Tunisia, it generally takes relatively more time to execute "small" deals in Tunisia (when compared to other more developed markets). Transactions typically take between 6 months and one year to be implemented. The difficulty to quickly execute transactions is due to a combination of factors.

- As previously discussed, negotiating the clauses of a typical term sheet is not an easy task because companies' managers and shareholders are not used to such transactions and are often advised by lawyers without any expertise in M&A.

- Sellers are rarely advised by investment banks, which makes the deal making process even slower. Sellers and managers need to take care of the entire process themselves while they have little or no experience in M&A.

- Due diligence can take a very long time. Financial statements are often not "clean" and need to be amended, in many cases there is no information available except for financial statements (relevant information would need to be collected from scratch) while a lack of transparence and a poor corporate governance need to be clarified.

- Sellers commonly have neither a solid business plan nor a clear strategy. PE professionals need to build a detailed BP along with the target's managers in order to be able to value the company.

- In order to (legally) circumvent the Tunisian regulatory constraints, PE professionals often need to put in place complex structures for acquisition purposes along with their legal advisors. There are often multiple vehicles in different countries and Tunisian shell corporations created *ex nihilo* to circumvent investment limitations and optimize fiscal structure. At the same time, the transaction structure submitted to the Tunisian regulators needs to be "simple". Buyouts are particularly difficult to implement because foreign entities (in particular offshore funds) need to ask for a special authorization in order to take a majority stake.

Besides, PE professionals use almost exclusively internal resources to manage deal executions. Typically, there is no investment bank involved in the process, the valuation is performed internally, most of the due diligence is processed by internal professionals (sometimes legal or accounting firms are hired to provide an opinion but internal professionals usually have control over the process). The recourse to external resources may vary from a PE firm to another but the cost can be non trivial (relatively to the small investment tickets) especially if the service providers are located in developed markets. Managers in Tuninvest-Africinvest for example built up a good understanding of term sheets through their deal experience; they now draft most of their term sheets internally.

C) The Holding Period

PE professionals investing in Tunisia agree that they have a very "hands-on" approach in their monitoring of portfolio companies. Private equity investors in Tunisia not only play a role in financing companies but also act like consultants and help managers in taking key decisions. There are essentially two levers used by PE professionals in order to increase value in their portfolio companies: improvement of corporate governance as well as strategic and operational help.

Enhancement of Corporate Governance

Prior to the entry of a private equity fund in the capital of a Tunisian company, corporate governance is often very weak. Typically, roles and responsibilities of shareholders and managers are not well defined; the limit between the company's treasury and shareholders' personal expenses is vague; internal processes are flawed; transparency and ethical behavior are blurry. Improving corporate governance is always a priority for PE fund managers when they invest in Tunisian companies. First, it helps them protect their best interest and have a clear view on the company's management and activity. Second, it enhances value creation through the improvement of the internal organization and the decision-making process. Third, it helps with exit through IPO or private sale in the sense that it makes the due diligence process much more straightforward and increase the valuation upon exit (lower downside risks for the potential buyer).

As they are often minority investors, private equity professionals need to make sure that their interest is well represented. In order to do so, they require one or several seats on the board of directors. They also often bring independent directors to avoid any conflict of interest and strengthen the independence of the board. They also commonly set up a strategic committee to improve communication with and between shareholders and managers. Such a committee plays a fundamental role in decision-making as the PE fund's representatives can formally advise founders and key people from the management on strategic decisions. Even though the strategic committee's members do not have any executive power, they help the board of directors and managers take acute decisions.

The clarification of roles and responsibilities is a second area of improvement. Private equity professionals see it as an essential step towards a better-working organizational structure. The roles and responsibilities of the different stakeholders (founders, other shareholders, managers at the different levels of the company) need to be precisely defined in order to provide each of them with a level of accountability and avoid any conflict of interest.

The institutionalization of portfolio companies also comes with the enhancement of disclosure and transparency. Internal control and reporting are improved and provide tools for shareholders and board members to have a better view on the company's activity, adjust processes accordingly, and take fact-based decisions. Regular internal control, auditing and reporting are meant to improve the performance of the management as they intend to check whether pre-set objectives (essentially through budget and planning) are met. They also help shareholders to ensure that procedures are performed as intended (more specifically integrity and ethical behavior).

Better internal processes and reporting not only intend to bring more transparency and improve disclosure but they are also essential to improve operations. Budgeting, planning and analytical accounting often contribute to understanding and analyzing in a more structured way the operational strengths and weaknesses of the portfolio company.

An example given by one of my interlocutors at Swicorp provides a good illustration of the value that can be created through such basic tools. Even though the company in question, Stepevi, is Turkish, the take-away can be transposed to Tunisian PE-backed companies as the investment pattern is often very similar. When Swicorp became a shareholder of the carpet manufacturer and retailer in January 2009, Stepevi had 28 outlets selling carpets and was overall profitable. Once Swicorp's representatives put in place analytical accounting (initially existent), it turned out that (roughly) half of the outlets were losing money. Without implementing any structured analysis of revenues and costs, the management used to think that closing some of the outlets would result in a loss of revenues. The results derived from analytical accounting revealed that their carpet business was not a "proximity" business since people were ready to drive 10-15km more to buy high-quality carpets. The introduction of analytical accounting materially improved efficiency as EBITDA increased by 20%.

Improving internal processes and reorganizing portfolio companies are only one part of PE professionals' contribution. Regular discussions are typically conducted along with key managers and shareholders in order to help with defining a clear business strategy and improving operations based on a thorough analysis of the company's competitive positioning and internal organization. There are several levers they can use to create more value.

One of the most important lever is to help the company scale up and use the PE capital injected to grow (most of the time organically). Top-line growth often comes with increasing market reach or diversifying products. The way growth strategy is implemented obviously depends on the sector and the company itself. There is no general rule but it is worthwhile to detail some of the options. Distribution capacity often constitutes a limit to manufacturing companies which aim to expand their market reach: due to a lack of large and efficient distributors in Tunisia, they typically need to have their own float to distribute manufactured products to their customers. The capital injected can also simply be used to increase production capacity (capital expenditures) or develop new products. PE professionals can leverage their contacts and network as well (possibly in other portfolio companies) in order to increase the customer base (notably in B2B or service-based businesses). When the company is or becomes a leader in its market and have opportunities to expand in other countries, the PE fund representatives can play a crucial role in helping it expand in markets where the rules of the game can be different (cf. "Focus on Regional Expansion" below).

PE professionals also often seek to improve the cost structure in order to improve profit margins. There is also no general rule in this case but cost structure rationalization often translates into streamlining business units, allocating resources in a more efficient way and improving the bargaining power with providers (concomitantly to the growth of the company). Headcount cuts are rare but they can be necessary when the "surplus" of headcount cannot be "recycled" within the company. In fact, as PE investments are most of the time growth-oriented they tend to create more jobs within portfolio companies.

Nevertheless, private equity professionals I interviewed make it clear that the implementation of a pre-determined strategy is not exempt from several hurdles. First, operating strategic shifts and reorganizing a company used to a family-type management often take time before results come into fruition. Even though the typical holding period (around five years) might need to be extended and exit delayed, new investors need to make sure that changes are not implemented

too fast not to disturb the company's activity. Second, private equity professionals often have to deal with internal rigidities specific to family-run businesses and external costs of doing business (e.g. red tape). Third, the strategic and operational changes initially defined are not set in stone. Private equity managers need to stay aware of market changes and potential industry reshapes. In a scenario whereby the change in market conditions implies a significant reshape of the portfolio company's business, PE investors need to make an extra-effort in terms of communication and "hands-on" operational help.

In this regard, Tuninvest's investment in IGL provides a good illustration of hurdles PE investors might face when significant changes reshape a portfolio company's market. When Tuninvest invested in the company, IGL had a promising business based on PC assembly. However, the market started undergoing a significant reshape after the investment had been made. Consumers changed their behavior and progressively started using more laptops than PCs. Tuninvest's representatives understood that adjusting the whole business model was vital for the company as the laptops' market share increased from 10% to 30%. This new trend was a major threat for IGL because laptops were much more complicated to assembly. While Tuninvest's representatives tried to push hard to switch the business from an assembly-based model to a distribution-based model, they faced a strong resistance from the founding family. This type of behavior is typical in family-run businesses as family members are often attached to their company's brand and model. The problem was solved only when one of the most "refractory" family members was nominated head of the distribution segment. In order to maximize the probability of success of this turnaround, one of Tuninvest's representatives undertook a hands-on approach and personally helped the management with operations. As a matter of fact, he went to meetings scheduled with managers in international computer manufacturers (e.g. Dell, HP, Lenovo, etc.) in order to pitch them and have a first-mover advantage over Tunisian competitors.

Focus on Regional Expansion

Typically, when a company is or becomes a leader in the Tunisian market, managers and shareholders (among which PE investors) can seriously ponder whether it would make sense for the company to expand regionally. Regional expansion offers a great option for domestic leaders to pursue double-digit growth and scale-up to the next level. Depending on the situation, regional expansion can be fueled either by cross-border acquisitions or by green field projects targeting new markets. Such strategy makes even more sense for Tunisian companies regarding the small size of the economy and the limited number of potential customers.

Expanding beyond the Tunisian frontiers is not an easy task though. Starting up a project in a new country often takes time as managers would need to start everything "from scratch" in a market they do not know. The rules of the game can be different in many regards: competitive environment, "administrative" hurdles, market for talents, regulatory framework, unions' power, procurement, distribution channels, consumer habits, etc. Even though most of those challenges are also applicable to cross-border acquisitions, when good opportunities are available, regional build-up through acquisitions has some advantages over starting up a greenfield project. The access to the new market would essentially be quicker and there would be potential value creation trough cost (e.g. better bargaining power with providers, overhead, resource sharing, economies of scale and scope) and revenue synergies (cross-selling, product duplications), technology and know-how sharing.

Potential candidates for geographic countries are mainly countries in the Mediterranean area (essentially North African countries, i.e. Morocco, Algeria, Libya and Egypt) as well as countries in Sub-Saharan Africa. In addition to the difficulties management may face in handling new

entities operating in structurally different markets, the lack of integration and cooperation among North African countries, between North Africa and Europe as well as between North Africa and Sub-Saharan Africa often adds a layer of complexity to implement a regional build-up strategy. Trade barriers and limits imposed to the circulation of individuals and capital make it more difficult to manage a regional group. More specifically, capital controls in Tunisia play against regional expansion of domestic leaders through cross-border acquisitions. In most of the cases, Tunisian companies need indeed a special authorization from the Central Bank to invest abroad. This constraint can be a deal breaker as the process takes time (practically three to four months as Central Bank employees need to review all the negotiation terms, the valuation, etc.) and can "kill" the momentum needed to close the deal with the foreign company (especially in a competitive bidding process). Complex legal structures can be put in place in order to facilitate foreign transactions. For example, the company can create *ex-nihilo* a holding company in a fiscally attractive country which can play the role of a platform in the context of cross-border M&A. Private equity investors can also be very helpful in accelerating the acquisition of foreign companies as they can take advantage of their USD or Euro-denominated funds to pay for the acquisition target. Ownership stakes in the holding company and its subsidiaries can be arranged *a posteriori*.

Tuninvest-Africinvest and Swicorp's investments in Altea Packaging are very good illustrations of how PE firms can help Tunisian companies scale up and become regional leaders through bolt on acquisitions. Altea Packaging (holding company) is a company specialized in flexible packaging.

The story of Altea Packaging[36] started with the Tunisian company Cogitel, founded in 1984 by a number of industrialists from Sfax, and started its operations in 1987 under the leadership of Hedi Zeghal (CEO). In 1998, Tuninvest injected capital in the company since the fund managers viewed the drawbacks experienced by the management in 1997 (closure of the Algerian border) as a good turnaround investment opportunity. The capital injected by the PE investors helped the company upscale its operations and improve products quality (ISO certifications). The company's success in becoming an undisputable leader in the Tunisian market convinced both Tuninvest and the Zeghal family that it made sense to transform the company into a regional leader in packaging.

In 2005, the company went through a leveraged management buyout (the first in Tunisia). As a consequence, Tuninvest partially exited and the Zeghal family increased its stake in the company (better alignment of management interests and PE investors). In 2006, Tuninvest made a follow-on investment in a newly created holding company (Altea Packaging) along with Swicorp. The investment thesis was to use the new holding company as a platform for a growth strategy mainly fueled by acquisitions. In 2007, the company acquired the French company Roland and started a greenfield project in Algeria ("Cogitela"). In 2008, Altea Packaging pursued its rapid growth through the acquisition of the Moroccan company Optima and two Egyptian companies (Porta and Rotopack). In 2010, Altea Packaging became the leading flexible packaging manufacturer in MENA, doubled its revenues in five years ($33 million), made significant efficiency gains (cost savings: energy savings, decline in waste rates, etc.), and expanded its footprint to five countries (Tunisia, France, Morocco, Algeria, Egypt).

Nevertheless, the success of the company under the investments made by the PE firms does not hide a couple of drawbacks. While the acquisition of the French company Roland made theoretically strategic sense (access to the French market and more widely the German, Benelux and UK markets; leverage Cogitel's expertise to produce semi-finished products and export them to the French unit), the implementation phase turned out to be much more difficult than expected. Bad finances showed up, the relationship with suppliers deteriorated, Altea Packaging's CEO (Slim Zeghal) took over personally the management of the company after having made

[36] "Sustainable Case Study: Cogitel (Tunisia)", EMPEA & IFC, 2011

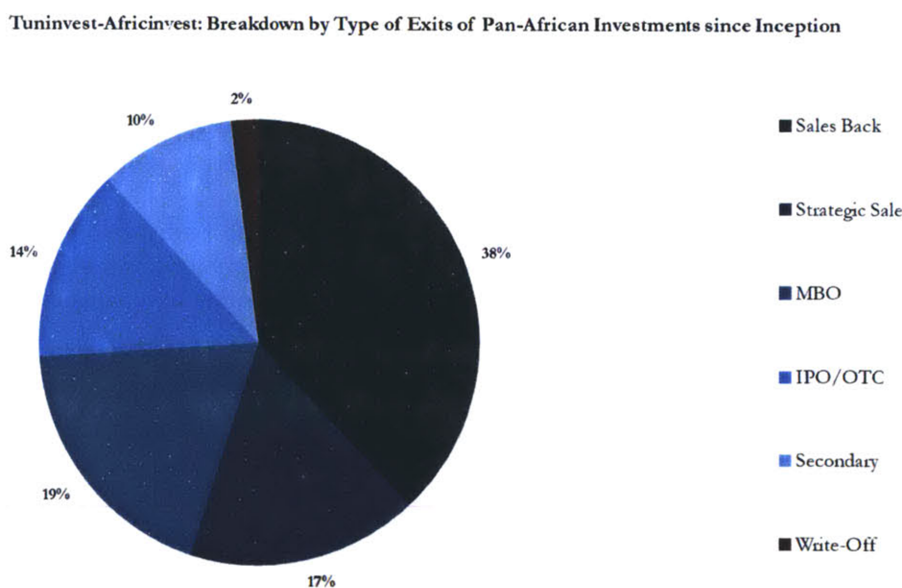
redundant the manager and the production manager of the French subsidiary. The rules of the game in the French business were very different with unions showing strong resistance and a workforce not flexible at all. On the other hand, successive crises (economic crisis in Europe, violent strikes and sudden interruptions of the production in Tunisia after the revolution) put even more pressure on cash flow sustainability in a business where operating leverage is high and margins are low. According to the CEO Slim Zeghal, Swicorp and Tuninvest's managers have been very supportive along the way.

D) The Exit Phase

There are typically four ways for PE firms to exit their investments: sale back to founders, private sale (strategic or secondary sale), IPO, leveraged recapitalization. While "leveraged recaps" (usually debt issuance followed by share buyback triggering a liquidity event) are almost inexistent, sale back to existing shareholders were historically the most common way to exit investment in Tunisia. At the same time, private sales are becoming more prevalent and IPOs more seriously envisaged.

I count 12 exits out of the 30 investments that have been made by offshore funds to date (cf. Table 2.4). 11 of them are exits from Tuninvest-Africinvest (notably from its first offshore fund Tuninvest International Ltd). Including investments in Tunisia *via* SICARs and investments in other African countries, Tuninvest-Africinvest exited 42 investments out of its 90 total investments. The breakdown by type of exits is displayed in Figure 2.19. While investments in other countries than Tunisia are taken into account, the breakdown provides an interesting dataset regarding the weights of the different types of exits (sale back, strategic sale and MBO represent almost ¾). The average holding period is 5 years, and the overall average money multiple is decent (2.3x)[37].

<u>Figure 2.19:</u>

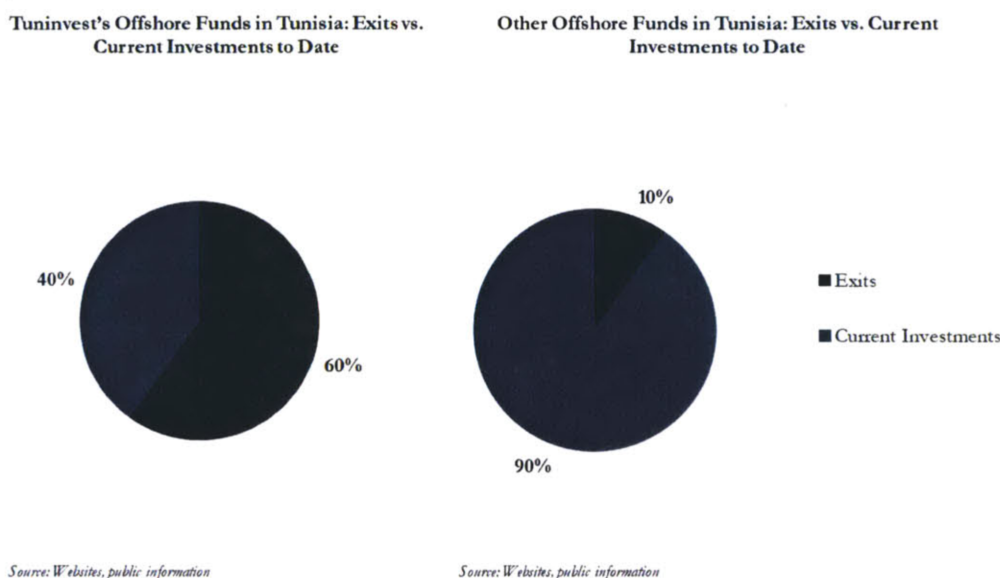


Source: Tuninvest-Africinvest's presentation available on the African Development Bank's website, June 2011

[37] Tuninvest-Africinvest's presentation available on the African Development Bank's website, June 2011

Other offshore funds have only exited one investment out of the 10 that have been made to date (Figure 2.20). Except for ECP's exited investment in Agromed which was made in 2003, all offshore funds other than Tuninvest-Africinvest (that have been investing PE capital in Tunisia since 2006-2007) have not made any exit yet. The current turmoil and the subsequent pressure on valuation levels in Tunisia (and more generally in the MENA region) have delayed potential exits in the pipeline.

Figure 2.20:



Sale Back to Founders

Before the first offshore funds started investing in Tunisia, SICARs had popularized exits through a sale back to the founder(s). Until recently, other types of exits have been very rare for two main reasons. First, the practice of carrying agreements (which have been widely used by SICARs) secures the exit at the initiation date of the transaction by forcing the founder(s) to buy back the shares from the investor according to a pre-determined schedule. Second, the lack of M&A activity and the limited scale of the equity capital market have constituted severe limits for a long period.

Private Sale

Private sales can take the form of sales to strategic investors or secondary sales (sales to other financial sponsors). With more offshore PE funds now investing in Tunisia, secondary sales are now a more plausible option than a few years ago (Tuninvest-Afrincivest was the only GP managing offshore funds). As the M&A market is becoming relatively more sophisticated, sales to strategic investors (either Tunisian or foreign companies) are getting more traction. European and regional players look indeed for the type of quality assets that private equity investors

typically nurture. Tuninvest-Africinvest divested in this regards several investments through strategic sale. Below are two examples of successful strategic sales:

- A stake of 29% in Galion (plastic packaging manufacturer) was sold to the Danish company Superfos in 2008
- A stake of 45% in Vitalait (milk producer) was sold to the Spanish company Kaiku for EUR 12.8 million

Strategic sales can be negotiated with larger corporations operating in the same general line of business as the portfolio company. Direct competitors or strategic partners can also have an interest in buying a PE-backed company. Such companies can see value in portfolio companies to the extent that the acquisition makes "strategic sense": revenue and cost synergies, geographic diversification, business diversification or industry consolidation, technology transfer. Strategic buyers are also often appreciated by existing shareholders in the sense that they can bring "business" value. Typically, the company can hire investment banks to find potential buyers and handle the sale process but this is not the standard for PE exits in Tunisia. From the PE investors' perspective, it also provides immediate liquidity (no lockup period such as in an IPO process). In order to attract more interest from strategic investors, shareholders can opt for a "dual track" (IPO and strategic sale processes are conducted in the same time).

However, there might be some drawbacks as compared to IPOs. While the price offered is more attractive than in sale back transactions, it is often lower than the price that PE firms and initial shareholders can get by listing the company. Managers might also be reluctant to sell the company when they feel that their position within the company is jeopardized.

Initial Public Offering

There are several advantages to take a company public:

- Get new capital to sustain growth/improve financial position
- Usually provides a better valuation than private sales
- Greater liquidity for firm's equity
- Potential increase in equity value (initial shareholders can typically benefit from future upside)
- Diversification of initial shareholders' personal portfolios and easier transfer of ownership
- Secondary offerings which offer initial shareholders the possibility to sell a large portion of their holdings
- Opportunities for future financing (through seasoned equity offerings)
- Makes mergers and acquisitions easier (more information available to potential buyers, stock used as a payment currency)
- Better image and visibility
- More efficient employee compensation strategies (stock options, restricted stock awards)

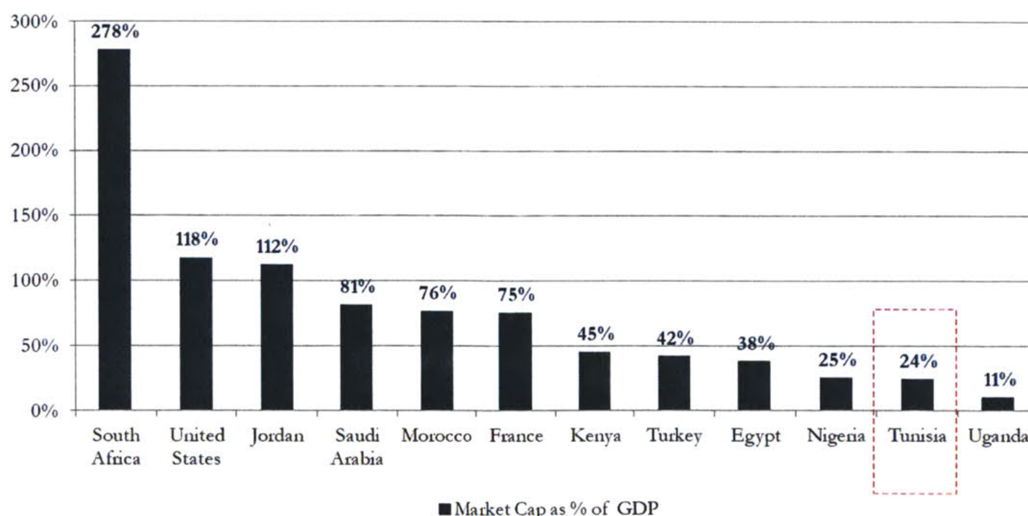
However, IPOs are not exempt from drawbacks:

- Direct and indirect expenses of going public (e.g. broker fees)
- Loss of privacy due to the necessity to release information before and after the IPO
- Costs involved in periodic financial reporting
- Fiduciary responsibility and loss of freedom by management to some degree (monitoring by board of directors, large outside shareholders)
- Higher risk of loss of control through takeovers (need to retain more than 50% ownership to maintain control)
- No immediate liquidity through secondary offerings (large shareholders cannot sell their stock during the "lock-up" period, typically 6 months)

In developed markets, IPO usually represents the best exit for VC and PE funds whenever the market is "hot". When the window is open, listing a company generally offers investors the opportunity to exit at attractive valuation levels. Therefore, the expansion of the Tunisian stock market is essential to the private equity sector. The public stock market might be considered in some cases as a potential "competitor" to private equity investors for equity fundraising. However, most of Tunisian companies which are not ready to go public might see a private equity investment as a way to strengthen their business and be more ready for an IPO. In developed markets, academic studies show that there is a correlation between exits and the stock market (market conditions affect the decision to exit). The concomitant development and sophistication of the private equity and the stock markets could create a strong positive feedback loop: private equity exits through IPO would help expand the Tunisian stock market, while from a long term perspective the development of the stock market could reinforce founders and PE investors' willingness to exit through IPO.

The stock market in Tunisia is relatively small compared to other countries (Figure 2.21). The total market capitalization of listed company was TND 14.5 billion by the end of 2011, which represents only 24% of the total GDP. The Tunisian stock market is still underdeveloped: only 59 companies are listed, the free float capital is low, the IPO market has been historically weak (on average 3 IPOs per year between 2006 and 2011), volumes traded are very low (TND 10.8 million per day in 2010 and TND 7.1 million in 2011)[38], many economic sectors are underrepresented, institutional demand is limited, market inefficiencies are numerous (stocks cannot fluctuate more than +/- 3% per day, no short-selling allowed, no derivative products, Tunisian investors' capital "trapped" because of currency controls). The economy is mostly financed by banks: even in 2009 and 2010 (years of strong activity), the stock market only represented 6% of private investments' financing.[39]

Figure 2.21:



Source: World Bank

[38] MAC SA Report, "Retrospectives 2011 et Perspectives 2012", January 2012
[39] Tunisie Valeurs Report, "Quel Marche pour l'Economie de Demain", July 2011

However, regulators have been pushing to develop the Tunisian stock market and a strong communication strategy has been undertaken since the revolution. Several measures are under consideration: push institutional investors to invest in the stock market (pension funds, insurance companies), lift progressively restrictions on foreign investors, list companies confiscated from the ex-president and his family, and privatize some of the state-owned companies.

Even though it is still undeveloped, the stock market is already a serious exit options for PE funds in Tunisia. As the market is still relatively small, there is a high demand for new stocks; IPOs are typically several times oversubscribed and provide attractive valuation levels. Capital gains realized *via* IPO are tax-free whereas they are now taxable for "regular" ways of cession with the introduction of the two statutory laws in October 2011.

3. Conclusions and Recommendations

1) Is Tunisia Attractive for PE Investors?

In order to sum up the main factors underlying the attractiveness of Tunisia for private equity capital, I implement a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats) based on the previous developments.

A) Strengths

- The Tunisian economy is a market-based economy, which creates the basic conditions in terms of competitive environment, potential for growth, goods markets efficiency and innovation. Attractive assets with a good management are available for potential private equity deals.

- Tunisia has an attractive geographic position in the Mediterranean area. This element constitutes a competitive advantage for potential regional expansions, exporting companies and funds adopting a regional investment approach.

- Even though the previous government did not manage to tackle internal imbalances (essentially unemployment), the sound public debt policy (relatively low level of public debt as a percentage of GDP) gives more room to help the economy reconcile with growth.

- The regulatory and legal frameworks are perceived as stable and relatively trustworthy (as compared to other countries in the region). This perception plays an essential role in terms of foreign capital attractiveness (in particular for offshore private equity funds).

- The fiscal framework is attractive as many fiscal incentives have been established in order to enhance investments and exports. More particularly, the absence of double taxation is crucial for foreign investors.

- The availability of a young, skilled, educated but relatively cheap labor can be seen as a strong competitive advantage (e.g. outsourcing activity, companies seeking organic growth).

- The presence of "professional" PE investors who are aware of the industry standards and are contributing to educating owners and managers about private equity investment is a positive development in the Tunisian market.

B) Weaknesses

- One of the greatest weaknesses of Tunisia from the perspective of PE investors is the small size of the country. The limited size of the economy, the population and companies

raises some concerns regarding the potential of the economy to absorb private equity capital. The low potential for scalability (exacerbated by the relatively low GDP growth compared to some emerging countries) and the generally small size of investment tickets remain major obstacles for investors to generate deals meeting their expectations.

- The high unemployment rate reflects in particular the inadequacy between supply and demand in the job market. Despite the availability of skilled labor, such inadequacy might hinder the growth of potential portfolio companies.

- Even though the regulatory and the legal systems are perceived to be "trustworthy" overall, the lack of clarity remains an important issue. This is particularly the case for the fiscal system as investors often complain about the comprehensibility of tax rules and fiscal incentives.

- Restrictions on foreign investments raise issues for offshore PE funds (domiciled in foreign jurisdictions). The problems subsequent to restrictions on foreign investments are mainly two-fold: first, foreign investors cannot buy a majority stake in a Tunisian company (unless they get a special authorization from the Central Bank); second, some areas such as distribution, real estate and agricultural lands (hence, companies owning plants or other tangible assets based on agricultural lands) are theoretically not accessible to foreign investors.

- Capital controls constitute another regulatory barrier for offshore PE investments. Foreign capital invested can be "easily" recalled by foreign investors upon exit; dividend payments and capital gains resulting from an exit can also be up-streamed. However, regional expansion through cross-border M&A or green field projects in a foreign country needs the approval of the Central Bank (the process can take several months before authorization).

- The flawed practices of many domestic funds do little to help with a positive development of the private equity industry in Tunisia. As previously discussed, it is still common to see aberrant GP-LP relationships, local funds set up exclusively to take advantage of fiscal incentives, fund managers using carrying agreements and having a hard time to meet the investment constraints conditioning the fiscal incentives. Despite some shortfalls, the two statutory laws promulgated in October 2011 show the authorities' willingness to tackle those issues.

- The lack of understanding by companies' managers and shareholders of private equity investments adds pressure on the deal flow (especially for offshore fund managers). Until recently, many companies (typically family-run businesses) do not see the value-added of private equity investors and are reluctant to open their capital. They are even more skeptical when they discover the negative covenants required by PE investors in proper shareholder agreements. The rules of the game are also often biased by the overwhelming presence of debt financing and the "relationship of trust" managers might have with their bankers.

- The lack of sophistication of capital markets and banks can also be seen as an important hurdle. The limited size of the stock market prevents IPOs from being a "natural" way of exit or financing. On the other hand, bank financing is often contingent to the availability of tangible collateral and acquisition debt is not a common practice (which makes leveraged acquisitions difficult to implement).

C) Opportunities

- The strategic position of Tunisia in the Mediterranean region and the availability of "quality" companies often focused on their domestic markets create a favorable environment for potential regional build-ups (regional PE investors would in particularly contribute their knowledge of foreign markets).

- From a top-down perspective, some sectors might be considered as attractive for growth capital (e.g. pharmaceuticals, industrials and manufacturing, agribusiness, ITC). While investments depends of course on the quality of target companies, the current position in the industry cycle of these sectors and the competitive advantages of Tunisia (potential for exports and outsourcing, skilled but relatively cheap labor, efficiency of the goods market, etc.) make them attractive for private equity investments focused on growth.

- The positive energies recently deployed around venture capital and entrepreneurship also generate great opportunities for early-stage investments as well as private equity in the long run (the "new" kind of more sophisticated entrepreneurs who might emerge can improve deal flow for later-stage investments in the future). Several initiatives undertaken after the revolution (private incubators, associations of venture capital and angel investors, events and symposiums dealing with entrepreneurship, etc.) are positively contributing to the entrepreneurship ecosystem.

- In the same way, the positive energies deployed after the revolution create direct opportunities for later-stage investments. Companies which used to be conservative in their expenditures under the previous political regime are now more likely to increase their investments in the future and potentially partner with PE investors in order to do so.

- While the current uncertainty and instability increase the risk of investing in Tunisia, companies' managers and shareholders are now more willing to discuss potential opportunities with PE investors and are more sensitive to their value-added.

- The uncertainty currently in place also makes valuation levels more attractive for PE investors, especially compared to those in the neighboring countries (e.g. Morocco). Potential targets are keener to factor in business and political risks in valuation.

- The current economic recession has put banks' balance sheets under stress. As liquidity is squeezing and non-performing loans are increasing, the contraction of bank financing might push companies' managers to seek more equity financing.

- The high demand for listed companies in a still underdeveloped public stock market makes the IPO exit somewhat attractive. The prospects of fruitful exits through IPO can have a positive impact on the deal flow and companies' willingness to open their capital to PE investors.

D) Threats

- The social instability and the capacity of the government to solve internal imbalances (notably the high unemployment rate) have adverse consequences on companies' operations (in particular PE funds' portfolio companies) and investor confidence. The persistence of instability might delay exits and change the risk/reward profile of PE investments in the country on the long-run.

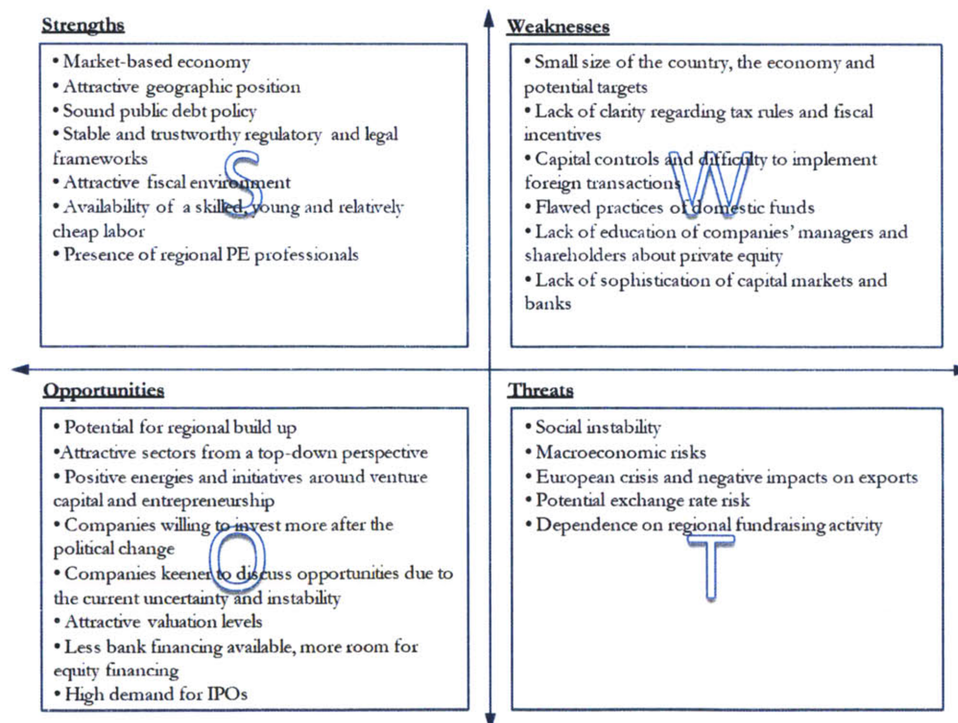
- The surge in macroeconomic risks also constitutes a major threat. Even though the government has room for borrowing foreign money, the deepening government budget deficit and the slowdown in GDP growth have a negative impact on investor confidence.

- The European crisis is a serious concern regarding the prospects of exports as Tunisian exporting companies are often highly exposed to the demand of the European market. Yet, the negative impact on trade imbalances might be reduced by European companies' willingness to reduce costs and outsource some of their operations in Tunisia.

- The increase in current account deficit also puts pressure on the Tunisian Dinar. The effect of a potential depreciation can severely impact offshore PE investors' returns in foreign-denominated currencies.

- The activity of offshore PE funds is highly dependent on the regional market conditions of private equity. The gloomy fundraising prospects in the MENA region might have a severe impact on offshore PE funds' activity in Tunisia.

E) SWOT Analysis Summary



2) Recommendations and Final Thoughts

As previously discussed, the benefits of private equity for the Tunisian economy are considerable. The Tunisian authorities and regulators seem to share this opinion as many initiatives have been undertaken in order to make the industry more dynamic. However, some flaws in the current system are persistent and need to be tackled.

While Tunisia is perceived as an attractive and competitive country by the investment community, some structural factors are still fraught with imperfections. One of the most important key success factors in my sense is the improvement of the regulatory framework for domestic PE funds. They currently play a major role in the industry and it is of utmost importance to improve their investment practice.

- Fiscal incentives at entry for local PE funds create a perverse dynamic in fund managers' investment approach. Many local LPs are indeed incentivized to set up PE funds only to take advantage of fiscal incentives. The subsequent lack of risk-taking constitutes a major flaw in the system: investors care more about the fiscal gain up-front rather than the capital gains made upon exit. Moreover, this type of funds set-up *ex-nihilo* by local banks, insurance companies or large groups are often not independent and managed by professionals who have no experience in private equity (or more generally in deal making and asset management). I believe that it is essential to withdraw fiscal incentives at entry as they distort the "rules of the game" and result in flawed GP-LP relationships. Such step would make investors more incentivized by performance and capital gains (which obviously needs to be taxed favorably as compared to ordinary income in order to provide incentives for PE investments).

- The investment constraints imposed to take advantage of the fiscal incentives up-front (obligation to invest in a limited list of eligible companies) have also deleterious implications. As a matter of fact, domestic fund managers often need to seal "bad" deals in order to make sure they respect the investment constraints providing fiscal incentives. In order to protect themselves from the excessive risk of equity in those cases, they typically use carrying agreements ("disguised debt"). However, authorities might still want to encourage certain types of investments (for example in underdeveloped regions). Fiscal incentives might be granted but it is crucial not to impose any obligation to make such investments in order to give more freedom to fund managers in defining their investment strategy. In this case, there would be no obligation for PE professionals to invest a certain percentage of their funds in a pre-determined catalogue of investments.

- More generally, any type of investment constraints needs to be withdrawn. In this regards, the two statutory laws soften the investment requirements but are still somewhat restrictive. For example, they still require that the funds have to be invested within two to three years after the capital is paid-in. I think it is more suitable to give PE professionals the freedom to contractually agree with their investors about the investment period, and more generally about any investment requirement.

- Private equity investors often complain about the lack of clarity regarding tax rules. The accumulation of "exceptions" in the tax code and changes made over time make it very hard for them to have a clear view on regulators' expectations. Communication and interactions between both parties are essential to help overcome the misaligned understanding of the tax code.

It is also essential to improve investment conditions for offshore PE funds in order to increase their deal flow. There are three important considerations to take into account in order to do so.

- Some of the "protected" sectors (e.g. distribution) need to be progressively made available for foreign investors (hence, offshore PE funds) to enhance competitiveness, enlarge the panel of potential targets and avoid any kind of "risky" legal structures aiming to (legally) "circumvent" the regulation in place.

- Because of their statute of "foreign investors", offshore PE funds cannot buy a majority stake in target companies (unless they get a special authorization from the Central Bank). This barrier makes it very difficult to implement buyout transactions.

- Capital controls constitute a significant hindrance for potential regional build-ups. In a best case scenario, such restrictions on investments made abroad delay transactions and might "kill" the deal momentum in the context of cross-border M&A. The fact that offshore funds have foreign-currency denominated money helps companies to avoid dealing with the Central Bank. Nevertheless, more flexible procedures would clearly withdraw an additional layer of complexity in deal structures.

While domestic PE funds play an important role in the private equity industry, offshore PE funds are at least as important. Offshore PE fund managers are indeed the "real" practitioner of PE investment (as compared to international standards) and they have a great role to play in educating companies' managers and shareholders. Co-investments along with local PE funds can also improve the general practice of private equity in the country as they would educate domestic PE fund managers during "live" deals. Nevertheless, such collaboration might not be possible at this stage since the gaps in investment practice and objectives in terms of minimum ticket size are considerable. They can however leverage the existence of associations (e.g. ATIC) in order to organize symposiums around private equity standards (for example how to properly structure a deal, how to incentivize selling shareholders and managers, etc.). In the same way, the creation of a strong ecosystem around entrepreneurship and venture capital (currently in progress) are crucial for early stage investments as well as private equity investments in the long term.

In addition to fixing the different flaws in the current system, the government also can make the PE industry more dynamic and efficient through a large public fund. While there were several attempts to create this kind of funds in the past (e.g. Foprodi which co-invests with domestic funds in companies meeting the "catalogue" requirements), the results have been disappointing mainly due to the low risk-taking approach, the lack of managers' skills and the overwhelming red-tape. A recent proposition made by the Ministry of Finance under the leadership of Jaloul Ayed (between the up-rising and the election of the Constituent Assembly) provides an interesting illustration of a potentially efficient implication of the government. Under this proposition, the government would set up a "large scale investment vehicle aiming to create value for future generations"[40]. The target final closing of the fund would be TND 5.0 billion (of which TND 2.5 billion from privatization receipts of the Tunisian government). Several types of sub-funds (categorized by asset class such as private equity, real estate, infrastructure, capital markets) would be created along with private and public investors (local and foreign institutional investors, sovereign funds, DFIs, etc.). Ajyal Fund's stake in each sub-fund would stand at 25% while 75% would come from other investors (lever effect of 4.0x). The new equity injected at the level of companies would help increase their debt capacity (lever effect of 2.0x on average). The total

[40] Ajyal Fund, "Tunisian Investment Fund for Future Generations", September 2011

amount of money that would be injected in the economy would be expected to reach TND 40.0 billion (=5.0*4.0x*2.0x).

I believe this kind of initiatives would help revitalize the private equity sector and the economy as a whole (Ajyal Fund's objectives: "stimulate investments, notably in rural areas; encourage entrepreneurship; spur job creation; encourage innovation; accompany the development of Tunisian companies abroad; reinforce capital structures of promising companies, notably SMEs; offer alternative financing tools to companies; renew the economic fabric and favor the emergence of a new class of business people"[40]). The increased private equity activity is not only meant to spur with the direct effects of investments made by the sub-fund focused on private equity but also with indirect effects of investments made in other asset classes. In this regards, the sub-fund dedicated to infrastructure investments is the exact form of "public-private partnership" that is needed to enhance the quality of infrastructure in the country (notably in inland areas). While this type of investments has not the same features as typical private equity investments in terms of lifecycle and returns, the improvement of the country's infrastructure can dramatically improve the efficiency of companies (e.g. better distribution network) as well as revitalize inland areas (and make them ultimately more attractive for private equity investments).

The theoretical framework and mechanics of Ajyal Fund are interesting and strong benefits can be foreseen. Nevertheless, several hurdles might hinder the implementation of the project. First, a fund of such size and ambition would require a number of skilled managers familiar with alternative investments and asset management in general. The success of the project is contingent upon the availability of operational talents. Second, the deal flow is limited in Tunisia and the capacity of the economy to absorb "effectively" this amount of money can be put into question. Therefore, I think that Ajyal Fund managers and managers of funds in which Ajyal Fund would be an LP should have a certain degree of freedom in terms of geographic target. This is especially important for offshore funds adopting a regional approach: Ajyal Fund would be an LP among others while Tunisia would be one of those funds' target countries. Ajyal Fund and domestic fund managers would naturally be more focused on Tunisia but other markets should not only be screened for potentially attractive transactions but also to ultimately accompany Tunisian companies in their regional expansion. Finally, Ajyal Fund could have at the same time an "LP" activity by providing a portion of the capital raised by domestic and regional funds but also a direct investment arm (in private equity). Should the fund manage to recruit operational talents with experience in private equity, direct investments can be a powerful tool to co-invest along with domestic fund managers and help them improve their practice in "live" deals.

According to my interlocutors, there is also a case to make for attracting offshore funds in Tunisia. Being a platform country for offshore funds would create a whole industry and many jobs as it is the case for instance in Mauritius. In Mauritius, it is mandatory to have recourse to a local accountant firm and have a local administrator in place. Offshore funds also generally work along with local lawyers for administrative procedures. The obligation to open accounts in local banks improves banks' liquidity and attract foreign capital (even though such capital is more volatile than DFIs). Authorities typically proceed to a thorough due diligence prior to granting a license to fund managers and a minimal taxation is in place (low tax rate on revenues other than capital gains in order not to be considered as a "tax haven"). Mauritius is currently the favorite jurisdiction for PE funds based in Africa thanks to its straightforward administrative procedures and legislation regarding the setup of partnerships, the attractive fiscal environment for GPs and the existence of a skilled local administration. While the example of Mauritius provides a good illustration of the potential benefits of being a platform country for offshore funds, the decision of implementing such strategy remains highly political (the economy would need to be much more open) and would require an exhaustive benchmark of jurisdictions attractive for offshore funds (e.g. Mauritius, Cayman Islands, Luxembourg, Isle of Man, etc.) in order to define an optimal positioning for Tunisia. Ajyal Fund can be leveraged in order to give birth to this type of

industry around offshore funds: as a prerequisite of being a limited partner in regional offshore funds, Ajyal Fund might for example require from GPs to set-up the fund in Tunisia, open local bank accounts (in foreign currency), have recourse to local accountants and lawyers, recruit a local administrator.

Finally, the recent political change and the current climate of uncertainty in Tunisia might entail significant investment opportunities for private equity investors in the short-term. Nevertheless, the resolution of internal imbalances, social instability and potential macroeconomic risks are crucial in the long run: the government's ability to tackle those issues will be decisive for the future developments in the Tunisian private equity industry.