British Private Equity & Venture Capital Association

BVCA Guides

GUIDE TO Private Equity & Venture Capital in the Middle East & Africa

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Introduction

Welcome to the BVCA Guide to Private Equity and Venture Capital in the Middle East and Africa, the first in a new series of guides produced by the BVCA designed to act as an introduction to international markets and business sectors.

The Middle East and North Africa (MENA) is a region that has long been on the radar of the international private equity community but it is only in the last few years that it has begun to attract genuine interest from Western private equity houses, and not just as a source of capital but also a destination.

This guide, produced by the BVCA in association with the MENA Private Equity Association (PEA), aims to provide an overview of some of the key issues, opportunities and challenges of investing in MENA. As an emerging market it offers superior economic growth rates and, there is now a very real appetite amongst companies in the region for investment and expansion. National governments too are fast becoming aware of the economic benefits private equity can bring, not just as providers of capital but also as importers of good business practice.

There are challenges, however, most notably around the economic and political environment. Many of these issues are addressed in this guide. But for the diligent and well-prepared investor there are significant opportunities to be had. Access to capital, which has been a concern of Western businesses since the financial crisis, is similarly a cause for concern for SMEs in the region. As companies look to grow and expand, private equity has the potential to step into this funding gap and present an alternative funding method to the traditional, and largely absent, banking market.

This, in part, is due to the global economic crisis, from which the MENA region has not been immune, yet there has been a strong rebound with investment activity quickly approaching 2007 levels. This increased attention from investors is testament to both their appetite for MENA and the resilience of the region to escape the worst of the financial turbulence over the past five years. But it is still an immature market, which is why the BVCA has been working with the MENA PEA to enhance both the understanding of the region to international private equity investors as well as supporting the home-grown market for domestic funds.

It is in this spirit that we present this guide to you. We hope you find it useful and we would like to sincerely thank our sponsors, Debevoise & Plimpton and Kroll Advisory Services, for their support.

Tim Hames
Director General
BVCA

Foreword

Africa and the Middle East are huge and diverse regions. To cover both in a few pages is a tall order, but one which has a lot of relevance for today's private equity market. In amongst the diversity, commonalities can be found, and no commonality is more pertinent that this – both regions are fast moving from the private equity margins onto the main stage.

In the past it was only the most risk hungry or highly specialised investors who viewed Africa and the Middle East with any eagerness. The problems were too many, the rewards too few.

It is perhaps going too far to say that those risks have disappeared – many of the old pitfalls remain, albeit with less frequency – but the reward side of the equation has moved significantly. Shifting and stabilising economies, increasingly favourable demographics, greater market knowledge, advances in tackling bribery and corruption: all these factors are moving in the right direction, and the region is now talked about in terms of opportunity rather than far-off potential. Larger sections of the private equity world are now looking at Africa and the Middle East with intent.

This intent is borne out in the numbers. In 2012, 20% of global private equity commitments went to emerging markets[1], the highest percentage on record. The growth of Africa and the Middle East as viable markets for private equity investment was a key driver behind that jump. In 2012 there were US$1.1 billion worth of private equity deals in Sub-Saharan Africa alone[2], and the MENA region saw a jump in the number of private equity investments from 84 to 91[3]. Contrasting this to the activity slump in many of the more traditional private equity markets, and a promising picture of the region emerges.

Of course, there remains a large amount of diversity and differences of approach across the region, but common themes and lessons can be drawn out, issues which come up time and again for private equity when doing business in Africa and the Middle East.

In this introduction to the regions, we aim to draw out some of those themes, and highlight the main issues facing private equity in Africa and the Middle East. We tackle it from both a legal and risk mitigation perspective, bringing together the expertise of Debevoise & Plimpton and Kroll as two firms at the forefront of global private equity.

In all, we look at five areas. First is deal structuring, in which we touch upon some of the ways to protect deals from the regional risks, and the importance of having an in-depth view of the relationships behind your deal. Second, we look at fund structuring, noting the structures which have most success in the region, what protections the structures ensure, and how fund structuring can be used to drive governance standards. Third, we turn to regulatory issues, flagging up the ways in which various jurisdictions are amending their regulatory environments to attract private equity investment, and the importance of understanding both the internal and external regulatory risks. Fourth comes operational issues, in which we stress the need to be aware of various sanctions in place throughout the region, as well as the hurdles that can arise from political and infrastructure limitations. Lastly, we look at corporate governance, giving an overview of the level of transparency in the region, and the impact governance can have on exit pricing.

There is no doubt Africa and the Middle East deserve the attention they are getting from the global private equity community, but we should not underestimate the many and varied obstacles to success. These are distinct markets with distinct issues.

David Innes
Debevoise & Plimpton LLP

Melvin Glapion
Kroll Advisory Solutions

[1] Emerging Markets Private Equity Association (http://www.empea.org/newsroom/empea-news/emerging-markets-private-equity-fundraising-takes-greatest-share-of-global-/)

[2] Deloitte 2013 East Africa Private Equity Confidence Survey (http://www.deloitte.com/assets/Dcom-Kenya/Local%20Assets/Documents/Deloitte%20PE%20Survey%202013.pdf)

[3] MENA Private Equity Association – 2012 annual report (http://www.menapea.com/research-association.php)

Deal structuring

Investing in the Middle East and Africa presents challenges both familiar and unfamiliar. In addition to the familiar issues around assessing financial performance and prospects, structuring to optimise tax treatment, ensuring appropriate levels of control and facilitating an exit, there are also a number of additional, unfamiliar issues to be considered.

These may include ensuring asset and investment protection from state interference (e.g., expropriation or corruption), structuring funding and exit to accommodate currency and similar financial controls, and minimising regulatory obstacles (often across multiple jurisdictions).

Bilateral investment treaties (BIT) may be available to protect investments against expropriation without adequate compensation. There are over 2,200 investment treaties in force and they can provide for international arbitration of treaty claims as an alternative to local courts. Depending on how a deal is structured it may be possible to benefit from more than one BIT.

Traditionally the majority of private equity investments in Africa have involved minority investments in young and emerging companies, as opposed to majority investments or in mature businesses. Minority investments naturally give rise to their own challenges, particularly in relation to control issues (or rather the lack of control) and difficulty of exit. It is therefore vital that appropriate contractual arrangements are agreed to provide investors' input in key business decisions and to protect the value of their investment.

"Ventures can be structured to take advantage of stable and familiar offshore legal regimes"

More so than in established markets, it is important that deal making is underpinned by strong legal expertise from the outset – from the negotiation of the initial term sheet through to structuring, funding and exit. Robust legal due diligence can aid in developing a deeper understanding of a target's unique cultural, legal and regulatory environment. Ventures can be structured to take advantage of stable and familiar offshore legal regimes, and bilateral investment treaties and tax treaties can be employed as powerful tools to protect an onshore investment, as well as ensure efficient capital deployment in Africa's developing legal and regulatory environments.

David Innes, Debevoise & Plimpton LLP

There was a time 10 years ago where Sub-Saharan Africa (SSA) was a no-go zone for most Western private equity firms and the Middle East was where you sourced funding, not invested it. Times have certainly changed.

> “The IMF reports that 11 of the top 20 fastest growing economies are located in SSA which explains the continued growth in both the number of funds and the amount of private equity funding directed at SSA investment”

As recently as four years ago, reports suggested that there was US$8 billion invested in Middle East focused funds. The IMF reports that 11 of the top 20 fastest growing economies are located in SSA which explains the continued growth in both the number of funds and the amount of private equity funding directed at SSA investment. These manifold opportunities come with equally varied and nuanced investment risks. Navigating them requires foresight, well-conceived mitigations and patience.

The greatest challenge most Western private equity investors have to overcome when investing in the Middle East and Africa (MENA) is the basic understanding of the extremely close nexus that exists between government or the ruling class and commerce. In many countries in MENA and SSA, they are often one and the same. For some of the larger companies in the region it is not uncommon for government or government-sponsored entities to be involved as an investment partner, a key customer or key supplier and industry regulator at the same time.

For Western private equity houses this presents both an uncomfortable and possibly even dangerous mix. One of the key concerns here would be for the portfolio company, and by extension the private equity investor, having invested in an asset which benefits from corruption or bribery and is in violation of the US FCPA or UKBA. The question here is whether the investment target, as a result of its owners’ or managers’ relationships with government, has received an unfair advantage - is the relationship quid pro quo?

The high degree of overlap between government and commerce in both MENA and SSA requires a significant degree of diligence on the part of private equity firms to understand not only the target company’s owners and managers, but also to further understand their broader business and political connections. A thorough and comprehensive level of due diligence is necessary and would focus on the company, its shareholders and senior management team.

The challenge in conducting thorough due diligence in both MENA and SSA is that there is very limited information publicly available. In some cases where information does exist, it is not uncommon to discover the certain key records are available to a select few (e.g., local lawyers) or that the information is incomplete, infrequent or simply incorrect. Therefore a central element to any investigation in both regions would be that of gathering human source intelligence. This would involve either the private equity firm or its advisers conducting discreet inquiries with company, industry and government sources in order to supplement, interrogate and challenge the information which may be available in the public domain. Only then can the private equity firm gain an understanding of a target’s network and be able to assess if any undisclosed government influence, ownership or potential expropriation arrangement might exist

The findings of the reputational or integrity investigation should then be used to develop an appropriate deal structure. This may include some of the following mitigations: replacing key management, requesting changes in ownership of a joint venture partner, securing anti-bribery/ anti-corruption audit rights, requesting representations and warranties that would protect from prior incidents of corruption, bribery and fraud.

Melvin Glapion, Kroll Advisory Solutions

Fund structuring

Despite investor optimism with respect to Africa, and particularly Sub-Saharan Africa, private equity fundraising remains relatively static. The combination of (i) a shortage of proven fund managers and (ii) a lack of established relationships between institutional investors and managers operating in the region is limiting the conversion of investor interest into committed capital.

There are various alternatives to a traditional private equity blind-pool fund that a manager seeking to deepen its track record or build a relationship with a prospective investor should consider.

Co-investment vehicles: For an established manager one option is to offer an investor the opportunity to co-invest with the manager's existing fund in a specific investment. Co-investments are often structured through a dedicated vehicle with the manager able to charge fees and/or carried interest. Such arrangements enable the investor to become familiar with the manager without requiring a long term, blind-pool commitment.

Deal-by-deal fundraising: A new entrant manager with identified investment opportunities may seek capital on a deal-by-deal basis. This allows investors to diligence the investment target while enabling a first-time manager to develop its track record and relationships with investors. Deal-by-deal fundraising requires the manager to front the costs of identifying and investigating investment opportunities, although these costs may be recouped when the fund vehicle closes, or sometimes earlier through a "cost sharing" agreement with prospective investors. This fundraising structure entails some deal execution uncertainty because completing the underlying investment depends upon a successful fundraising.

Pledge fund: For a new manager, or one expanding into a new strategy/region, another possibility is to offer investors a pledge fund structure where the commitment of each investor can only be drawn if the investor elects to participate in a specific underlying investment. Similar to deal-by-deal fundraising, each investor can diligence an investment target before deciding to participate, but, unlike deal-by-deal fundraising, the manager can avoid forming separate fund vehicles or negotiating new terms and documents for each investment. Pledge funds often enable a manager to charge a management fee on subscribed capital to cover the manager's costs in analysing investment opportunities, although they also include an element of deal execution uncertainty because investors may elect not to participate in a given investment opportunity.

Geoffrey Kittredge, Debevoise & Plimpton LLP

"A new entrant manager with identified investment opportunities may seek capital on a deal-by-deal basis"

While a few global private equity players have successfully managed to secure funding for Middle East and North Africa (MENA) and Sub-Saharan Africa focused funds, the challenge remains monumental for private equity investors seeking to establish themselves in the region.

The challenge lies in the fact that (a) local and regional private equity have established networks, and hence more frequent and reliable deal flow, and (b) local and regional players have greater access to MENA and SSA capital, including sovereign wealth funds and Sharia compliant capital.

While many private equity firms have an interest in MENA and SSA opportunities, most Western private equity firms or managers need to rely upon co-investing at the outset. The risks here then becomes how to manage an investment with one partner from a limited pool of potential partners who is likely to require control over key strategic and operational issues

As in deal structuring, the need to know your partner is paramount. The central focus of the co-investment partner due diligence is to assess whether the co-investor can deliver the required resources and capabilities in a manner that aligns with the Western private equity firm's expectations and requirements.

The due diligence should examine the potential co-investor's previous interactions with other partners, its strategic and operational intent, sources of funding, as well as its reputation within the local and regional market. This type of information is unlikely to be assessed from public domain research as the MENA and SSA regions have limited accessible public records information. A series of human source interviews combined with public records information and the Western private equity firm's own intelligence will allow the firm to create a composite view of the potential co-investor.

> "As in deal structuring, the need to know your partner is paramount"

The refrain from many private equity houses with respect to this level of inquiry is that the process seems invasive and may risk insulting, or worse, repelling a crucial co-investor. The fear of such repercussions often leads to firms conducting surface level research or assuming that because a potential partner has worked with one well-known Western firm, there is little risk to the establishing a similar relationship.

The fear of insulting a co-investor with extensive partner due diligence is overblown. Most of the key potential co-investors are accustomed to the due diligence requirements and investigative approaches employed by Western partners. In fact some of the co-investment partners require similar partner due diligence to be conducted on the potential Western PE investor.

Certainly, the due diligence process carries with it the possibility of repelling a potential co-investor but fully understanding a potential co-investor and his business reputation can mitigate a host of costly potential challenges and disputes. Indeed, it is better to be assured you have the right co-investor at the deal funding stage than to be certain you have the wrong co-investor mid-way or when exiting an investment.

Melvin Glapion, Kroll Advisory Solutions

Regulatory issues

In emerging market fundraising the Middle East has taken centre stage. Sovereign wealth funds (SWFs) in the region have become increasingly active and experienced, and have invested in or partnered with well-known Western private equity firms in an effort to increase their penetration of the asset class.

The regulatory environment in the Middle East, however, has historically posed challenges for Western private equity firms raising capital in the region.

The United Arab Emirates (UAE), Kuwait and Bahrain passed laws making it harder to access their investors without going through a fund registration process and a locally licensed entity, to reflect the position in Saudi Arabia for a number of years. This caused difficulties, particularly in the UAE. Western fund managers found themselves technically unable to meet with the likes of the Abu Dhabi Investment Authority (ADIA) and the Abu Dhabi Investment Council (ADIC), even if these entities requested a meeting.

This looks set to change though. The UAE recently amended its laws to allow fund managers to promote funds to local SWFs and other institutional investors. The Kuwaiti regulator also appears to be softening its stance. Saudi Arabia, traditionally the most restrictive jurisdiction for raising funds in the region, is consulting on changing its laws, potentially allowing marketing to SWFs and other institutional investors.

As an investor, the UAE has arguably been the most active in the region. Its two principal SWFs, ADIA and the ADIC, have become two of the world's most active investors in the alternative asset class. SWFs in Saudi Arabia, Kuwait and Oman are also increasingly active investors. This has been partly responsible for these countries looking to relax the restrictions on offering funds to local SWFs and institutional investors.

As to deploying private equity capital in the region, the political landscape in the wake of the Arab spring has made many Middle Eastern and North African countries no-go areas for investment. In countries unaffected by the political turmoil of the Arab spring, the legal and regulatory environment remains unsupportive of venture capital and private equity investment.

A prime example is Saudi Arabia, where reforms have been slow. It remains difficult for Western firms to invest locally, and for local businesses to access private capital. It is likely that any Western venture capital or private equity firm looking to make investments in the region will continue to face these regulatory and legal challenges for some time.

Marwan Al-Turki, Debevoise & Plimpton LLP

"The UAE recently amended its laws to allow fund managers to promote funds to local SWFs and other institutional investors"

While there have been a host of regulatory frameworks implemented or revised over the last four years, the most debated issues have been those around anti-bribery and anti-corruption legislation. There has been much discussion about the applicability of UKBA and other similar anti-bribery/anti-corruption legislation to private equity firms.

A number of firms still believe the risks to them are minimal: in the Middle East and North Africa (MENA) and Sub-Saharan Africa (SSA), Western firms are often minority shareholders. They assume that as minority shareholders they are unlikely to be significantly implicated if a portfolio company falls foul of the law.

This view is misguided. Firstly, even as minority stakeholders, Western private equity firms will serve on boards of portfolio companies. Board-level representation gives the firm a greater degree of control and influence and this could give reason to a regulator to implicate both the suspected company and its owners.

Secondly, there is the possibility that the regulator can pursue civil recoveries of disbursed funds. A recent example was noted in 2012 with the engineering firm Mabey & Johnson. In this case the Serious Fraud Office (SFO) pursued and won civil recovery against the Mabey & Johnson parent company for dividends it had received from a subsidiary company that had engaged in corruption to secure Iraq bridge-building contracts. The case highlighted the UK government's intention to pursue all proceeds, even dividends to shareholders that are totally unaware of the crime. In a statement at the time the message from the head of the SFO was that "shareholders who receive the proceeds of crime can expect civil action against them to recover the money. The SFO will pursue this approach vigorously. In this particular case, however, the shareholder was totally unaware of any inappropriate behaviour.

The other challenge as it relates to the regulatory environment is the degree to which compliance with US/UK guidance on preventing corruption and bribery are being hampered by local or regional regulatory constraints. A case in point is the advice to conduct risk-appropriate due diligence on potential third parties. A proper investigation would involve assessing the risks of corruption or bribery and would involve an element of public records research, and most importantly in the MENA and SSA regions, a number of human source interviews.

> "The best way to mitigate is for Western private equity firms to expand the degree and scope of human intelligence"

Recently, however, a number of countries in MENA and in SSA have either passed or are seeking to implement data protection laws that will markedly restrict access to previously accessible public information. Essentially what we have is a group of countries that pose some of the greatest risks with respect to corruption and bribery, now enacting legislation that makes it even harder for outsiders to investigate whether they are engaged in unlawful behaviour. The best way to mitigate is for Western private equity firms to expand the degree and scope of human intelligence. The approach is appropriate for the level of risk the region presents and is considered best-practice for any joint venture or M&A transaction in MENA or SSA.

Over the last several years, we have witnessed that the greatest and most dramatic increases in GDP growth year-over-year have occurred in those countries that scored lowest in regards to transparency. A large number of those countries are in the MENA and SSA regions. The expectation is that investors will continue to focus more heavily on both regions as Western economies continue as improved but anemic rates of growth. Yet the trend seems to be more opacity, not less—a cautionary trend for any Western investor.

Melvin Glapion, Kroll Advisory Solutions

Operational issues

In a global economic environment where mature markets are showing anaemic growth, investing in the Middle East and Africa offers the possibility of index-beating profits. While business and political risks are generally well understood, investors also need to beware the risk that a proposed investment falls foul of the increasing array of economic sanctions imposed by a variety of international actors. Sanctions generally target the regime of a particular country and will typically prohibit trade in certain goods or services, and dealings with certain individuals or entities. In some instances, they will also restrict money transfers.

Sanctions are imposed by actors such as the European Union (administered and enforced by the Member States), the US (through the Office of Foreign Asset Control), and / or individual countries. Many of the non-democratic or "rogue" states the international community attempts to discipline through sanctions are found in the Middle East and Africa, regions which remain politically very volatile. Pre-investment due diligence for any direct or indirect investment in these regions should therefore cover both current sanctions and the risk of sanctions being imposed in the future. With the number of actors imposing sanctions, it will not always be obvious which regime(s) applies and for any given investment. It may be necessary to interact with a range of regulators to obtain any necessary licences, exemptions or guidance.

The due diligence necessary to mitigate the sanctions risk may feel like burdensome red tape. The alternatives, however, are unpalatable: dealing directly or indirectly in a sanctioned sector, or with a sanctioned entity or individual, may mean the loss of an investment, fines, and even imprisonment. Putting in place appropriate control mechanisms needs not be onerous and, as always, prevention is better than cure.

Robin Lööf, Debevoise & Plimpton LLP

Most savvy Western-based private equity firms are well aware of the operational risks that are inherent in emerging market investments. Many that approach the Middle East and North Africa (MENA) and Sub-Saharan Africa (SSA) regions fail to account for the heightened impact some of these risks carry and the nuances necessary to mitigate them. There are four general areas of risk where we generally advise greater caution for investments in the Middle East and Africa.

Human resources: In many jurisdictions there is a scarcity of qualified local executive talent. More often than not it will be necessary to hire either an expatriate or a local manager who has had significant experience outside of the country or region. The challenge in both scenarios is that getting a full picture of the candidates' reputations and qualifications is difficult. A proper reputational investigation involves understanding the history of the candidates in each of the countries where they have spent a meaningful amount of time as an employee. This level of scrutiny is necessary to identify potential future issues and management challenges.

Another human resources challenge involves corporate communications. Policies and procedures, as well as management emails to local staff, can sometimes be perceived by local employees as not intended for or relevant to them, or the message can be simply lost in translation.

Recently we conducted an anti-bribery/anti-corruption audit of a UK-based portfolio company of European private equity firm. The management team at the company headquarters and leadership of the firm were certain they had made clear to all of the company's employees the importance of adhering to anti-bribery/anti-corruption policies. The company had conducted several one-on-one training sessions in each major location and had issued regular communication updates on how the policy was being implemented around the world. Our assignment was to determine how effectively the message was filtering down to employees, particularly in the Middle East and African offices. Our findings indicated 98% of employees had attended a training session in

> "It may be necessary to interact with a range of regulators to obtain any necessary licences, exemptions or guidance"

“Western firms should ensure that its portfolio companies are putting in place the appropriate compliance infrastructure”

the previous 12 months, but in response to our interview questions, employees in the Middle East and African offices were more likely indicate a lack of awareness or concern for company policies and procedures. Of the messages we heard most were “things work differently here” or “the company needs to say that, but doesn’t really expect us to act that way here”.

Western firms should ensure that its portfolio companies are putting in place the appropriate compliance infrastructure (e.g. qualified training teams, specific and adaptable local training, multi-lingual whistle-blower hotlines or ombudsmen) as well as requiring regular audits to assess these risks.

Intellectual property: An increasing trend to develop and house more intellectual property (IP) in MENA and SSA portends a greater challenge in protecting valuable customer data, IP, or trade secrets. The risk of loss of competitive advantage, loss of sensitive information or even a temporary inability to trade, pose financial, operational and reputation risks for private equity firms and their portfolio companies. The best way of mitigating against this risk is firstly to assess what is sensitive and valuable data and secondly to determine where it is housed and who has access to it. Thereafter, plans for protecting that data from external (hacking) and internal (malicious or negligent employee) should be drafted, tested and monitored. In our experience of assisting firms in investigating data breaches, the greatest obstacle at the outset is determining where its sensitive information is kept.

Infrastructure: While the Middle East continues to invest in a robust infrastructure, recent reports by the African Development bank suggest that infrastructure investments of US$90-100 billion are required over the next seven years to build or maintain power, transport, water and telecommunications infrastructure in North and Sub-Saharan Africa. The practical aspects of the infrastructure challenges are often overlooked by Western private equity funds entering the region. These can include frequent and sustained power outages, or poor or non-existent roads in several countries.

Depending upon the industry sector, the operational costs of poor or inadequate infrastructure can be significant. Mitigating risks here involves an understanding where infrastructure challenges exist for each investment and then working with partners, suppliers, and employees to implement business continuity plans. In some cases a necessary component is the company’s direct investment into building the necessary infrastructure to support business operations - for example, paving roads to factories or investing in schools and hospitals to attract employees.

Crisis management: There is no question that the recent unrest in the Middle East and the on-going uncertainty over the future leadership of Syria and Egypt are having a major negative impact on the growth prospects for many investments in the Middle East and North Africa. And despite regular reports that Sub-Saharan Africa is experiencing a sustained period of political stability, there is no guarantee there will not be unrest in a number of high economic growth countries ruled by entrenched and notoriously corrupt regimes.

Western private equity firms are diligent in assessing the political change calculus at the outset of an investment. Ensuring that there are plans for on-going political monitoring or scenario planning for responding to emerging crises, however, is not often as robust. While no one can predict with certainty when and where the next political uprising will occur, country-specific scenario planning is an important and necessary mitigation. Key considerations should be employees, facilities, goods and finances (e.g., repatriation, payment of salaries, etc.). Additionally, developing and maintaining a reputation for integrity in business is often the best way to ensure the investment has a level of local protection when political unrest or change occurs.

Melvin Glapion, Kroll Advisory Solutions

Corporate governance

Corporate governance has many elements in Middle East and African private equity investing. Among these are operational governance, minority protections, and management of publicly traded companies.

Foremost, private equity firms should carefully consider the operational governance of target companies since corruption can be a big issue - many African nations rank relatively low on Transparency International's *Corruption Perception Index*. Often, corrupt payments are buried within complex agency or other contractual arrangements, which can make identifying 'red flags' difficult. Diligence starts by getting to know your counterparties and their general approach to doing business. Lawyers can augment the work of an investigative firm at this stage of the process.

Whether diligence uncovers compliance issues or not, a prudent private equity investor will outline its own approaches to compliance and transparency, with the principal aim of ensuring its business model and strengths are understood locally. Establishing firm footing for sound business practices and an intolerance for non-compliance will help establish a culture of good corporate governance and transparency, as well as implement the investor's own compliance safeguards.

The second facet of governance in Middle East and African deals is the position of minority shareholder protections in private companies. A private equity investor will want to understand what rights are granted under law, what supplementary protections may be needed, and how enforceable its rights will be under the chosen law and dispute resolution arrangements. For instance, if corporate disputes must be governed by local laws and resolved in local courts, the investor will need to assess what protections may be missing under local law, how quickly court actions get resolved and how vulnerable court institutions are to external interference.

"Establishing firm footing for sound business practices and an intolerance for non-compliance will help establish a culture of good corporate governance and transparency"

Of course, rarely are such issues show-stoppers. However, they very well may affect the fund's risk/reward analysis.

Finally, potential investments by private equity and hedge funds in publicly traded companies should be analysed from the view point of management entrenchment. Issues include the difficulty of presenting topics for consideration at board or shareholder meetings, executive compensation, and corporate defences to eventual takeover bids. These matters are typically governed by the law of the company's incorporation, applicable securities regulations and the rules of the relevant exchange(s).

Geoffrey P. Burgess, Debevoise & Plimpton LLP

“Managing risks within this context requires an understanding of what governance procedures are in place and how effective they are”

Corporate governance in emerging markets in general has historically been regarded as woefully inadequate. Years of sustained investment into many emerging market economies has resulted in proactive steps to improve the situatuon, but the weak corporate governance in the Middle East and North Africa (MENA) and Sub-Saharan Africa (SSA) have often been cited as concerns for those investing the region as well as those avoiding them altogether.

While there is an acknowledgement at both the corporate and government level that governance needs to accelerate its rate of improvement, data from BRIC countries suggest changes do not come quickly. In fact, we analysed data compiled by Transparency International from 10 years ago. We used TI's *Corruption Perception Index* (CPI) as a proxy for the levels of corporate governance. The results showed that for each of the BRIC countries, CPI scores from 2002 were essentially unchanged from CPI scores in 2012. In spite of the vast sums of foreign direct investment by Western corporates, private equity and development finance institutions, the level of corporate governance has remained stubbornly low as compared to Western standards.

As many in the private equity industry have commented, part of the explanation is cultural. Emerging market economies do not have a history of transparency and governance issues - in the Western world it took time for these to become established as business norms.

One of the greater challenges, however, is that in both MENA and SSA, a significant component of both private equity potential targets as well as sizeable portions of the economy are small to medium enterprises (SMEs). There are estimates that over 65% of MENA GDP is controlled by SMEs. SMEs do not have to resources to invest in compliance and governance structures, even if they are well-intentioned. Moreover, they are often closely-held businesses whereby one or two shareholders have historically been the key decision-makers and governance, particularly as they relate to shareholder rights or separation of management and ownership tasks have not been necessary issues they needed to address.

Managing risks within this context requires an understanding of what governance procedures are in place and how effective they are. In many, instances, Western private equity firms will need to communicate the need for greater transparency and governance structures and will likely have to be prepared for the investment in a governance infrastructure. Private equity firms should also insist on conducting a governance audit in the first 100 days as well as annual governance audits at portfolio companies.

As we have mentioned, Western private equity is often a minority shareholder in investments in the MENA and SSA regions. Consequently, implementing a process of governance audits often requires a certain degree of influence to be budgeted for or even implemented. Conditions for the audit should be negotiated early on in the process. Equally important is to negotiate how issues are investigated and resolved once found. Again, as a likely minority investor, Western firms may find it difficult to demand an internal or independent investigation if there is not an agreed method for dealing with these issues.

Finally, despite the PE industry having been subject to increased and more complex government oversight and regulation, individual private equity firms with a focus on the MENA and SSA regions need to work with industry associations to lobby MENA and SSA governments to provide greater transparency as well as to expect better governance from industry. Convincing governments to improve the quality and quantity of public records and providing them in a manner that is easily and equally accessable should be a priority. Such arguments can be made by private equity firms and associations themselves or in conjunction with development finance institutions and large institutional investors and can only serve to improve corporate governance in the Middle East and Africa and, most importantly, to further improve the level of investment going into the region.

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