Public Policy Forum on Venture Capital and Innovation

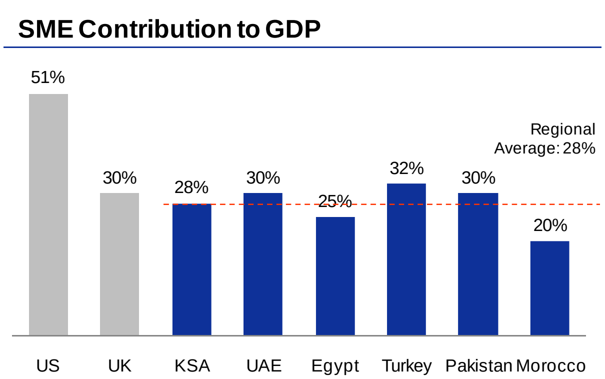
The MENA[1] Perspective

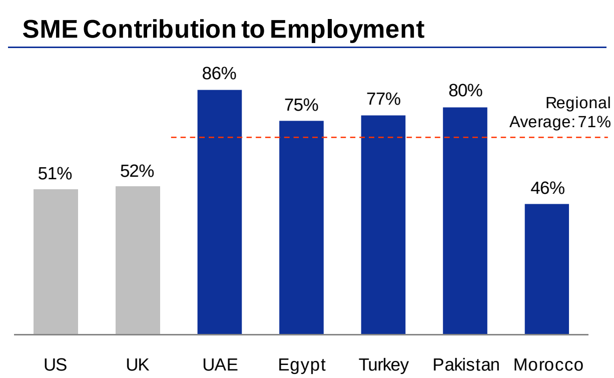
October 25, 2010

1. THE MENA ENTREPRENEURSHIP ECOSYSTEM

Relevance of the SME segment in the MENA region

Across the broader Middle East region SMEs account for c. 71% of jobs and 28% of GDP[2]. Given the significant contribution to employment, in a region not known for high employment levels, the SME segment is rightly seen by governments and observers alike as perhaps the most important in the corporate landscape of the region. SMEs are increasingly also being seen as a motor for future economic growth. Already, SMEs dominate in many fast growing industries in the region such as technology, media and telecommunications. At the same time, SMEs are playing a critical role in transforming traditional industries such as healthcare and education through innovative business models. Generally there is an acceptance that SMEs can contribute disproportionately to future GDP and job growth and according to some reports have the potential to contribute an additional GDP of US$ 100 billion and up to 2 million jobs in the coming years in the GCC[3] alone[4]. There is evidence for this in more developed markets such as the United States and Germany as well as within the region itself. For example, in Egypt the fastest growing segment in the corporate landscape is the medium segment, with the number of these enterprises having increased at a rate of 5.7% from 2006-2008 versus an increase of 0.3% in the total number of enterprises and a decrease of 8.5% in the number of large enterprises[5].





[1] MENA (Middle East and North Africa) means the region principally comprising the following countries: Algeria, Bahrain, Egypt, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestinian Territories, Qatar, Saudi Arabia, Tunisia, Turkey and the United Arab Emirates

[2] Various government ministries. GDP contribution data based on Saudi Arabia, UAE, Egypt, Turkey, Pakistan and Morocco, which collectively represent 76% of the GDP of the Region. Employment contribution data based on the UAE, Egypt, Turkey, Pakistan and Morocco, which collectively represent 80% of the population of the Region.

[3] GCC means the countries of the Gulf Cooperation Council, consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates

[4] AT Kearney

[5] CI Capital

Despite the significant contribution to employment, regional SMEs are not delivering a proportionate amount of input to GDP. When comparing SMEs in the region to their global peers, a significant disparity in terms of productivity is readily apparent. For instance, although on average SMEs in the region contribute 39% more to employment than those in the US (71% versus 51%), the contribution of these same SMEs to GDP is 45% less (28% of GDP versus 51%). In fact, a closer look at certain sectors such as manufacturing reveals a significant 'productivity' gap. For instance, when compared to SMEs in the region, output per employee for manufacturing-based SMEs is 11x greater in the US and 6x greater in the UK. Evidence indicates that the higher ratio of output/employee in these developed markets implies that SMEs in the region continue to suffer from factors such as: (a) lack of investment in productivity-enhancing technology and machinery and a corresponding reliance on low-cost labor; (b) lack of access to capital for purposes of expansion, scale, etc; and (c) lack of institutional processes including IT systems for back office processes and general support in terms of business sophistication/practices.

Importance of SME segment

By way of summary of the importance of the segment and the related investment opportunity:

- There exist in the region a vast number of SMEs that collectively account for the largest share of employment; and that consequently represent the core base of economic and social stability within the region.
- The growth potential of these businesses is inherently great because they operate in high-growth emerging markets with supportive macro-economic drivers including demographic change, government reform/systemic change and historic undersupply.
- Furthermore, SMEs are currently underserved by the financial sector, including banks, capital markets and private equity/venture capital. They also lack access to sophisticated business practices and know-how. Generally their growth potential is systemically held back and pent-up.
- Finally, SMEs are currently unproductive by comparison with their global counterparts and a further delta of growth can be achieved by means of productivity enhancing technology and know-how.[6]

Lack of Institutional Capital for Entrepreneurs

Access to capital is a great challenge for the vast majority of SMEs in the region. In terms of bank financing, SMEs only account for 8% of total bank loans[7]. Even in markets with more developed financial sectors such as in the UAE the rejection rate for SME loans is over 50%, with a primary reason cited as the low levels of collateral available. Banks, it seems, focus on asset based lending rather than cash flow based lending to the SME segment, whereas many SMEs do not have a significant asset base. For those SMEs that are able to obtain loans, the cost of such financing can be prohibitive, at interest rates of typically between 15-20% p.a.[8]. Furthermore, the nature of the debt available is unlikely to be anything other than short term. In Saudi Arabia, for example, over 90% of loans made to medium-sized

[6] A potential side effect of increased productivity and efficiency is lower employment; but this should be offset by the overall economic growth that follows the other factors for unlocking value in the SME segment.

[7] World Bank

[8] Dun & Bradstreet

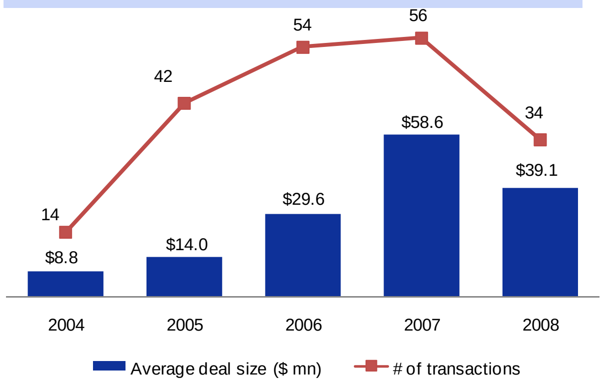
enterprises have tenures of 1 year or less[9]. The lack of available bank financing is even more acute in countries such as Egypt, where only 10% of SMEs receive working capital support and only 13% have access to any formal credit (as compared to a figure of 36% for large enterprises)[10]. Matters have been exacerbated by the recent global downturn, with many banks liquidity constrained and/or more risk averse.

More fundamentally, there is a dearth of strategic equity capital available from institutional investors such as private equity and venture capital firms. Private equity and venture capital firms are vitally important to the entrepreneurial ecosystem in more developed markets. The nature of the equity capital provided through these channels is generally better suited to the SME segment than bank debt. It does not typically carry an on-going cash flow servicing requirement like interest and there is often no amortisation or refinancing risk down the line. This gives the business room to grow and free cash flow can be channelled towards growth. In addition to capital, private equity and venture capital can provide additional institutional support to entrepreneurs including strategic and operating expertise and access to broad business networks.

Unfortunately for SMEs in the region, relatively little private equity or venture capital is available to that segment. For example, the average private equity transaction in the region has increased in size from US$ 9 million in 2004 to US$ 59 million as of 2007[11], indicating a shift towards larger transactions at the expense of the SME segment.

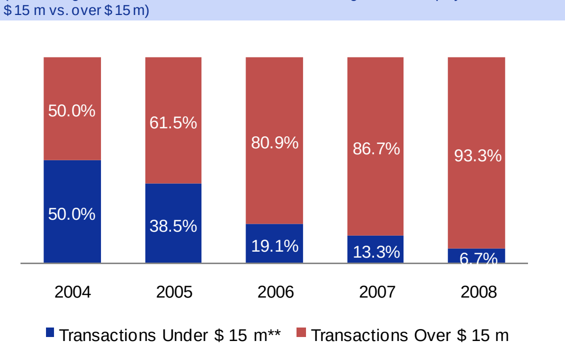
Regional PE funds have been increasingly investing larger ticket sizes…

(US$ million, except for number of funds)*



…As a result the SME sector has been largely ignored

(% showing the relative number of transactions involving firms with equity value of less then $ 15 m vs. over $ 15 m)



This is not an issue that is unique to the region, of course. Even in the most developed markets the private equity industry has typically allocated significantly greater capital to larger more mature corporates, where the perceived risk of loss is much lower. The situation is perhaps well reflected by the experience of the United States in the 2000s, where the growth of capital available to the private equity industry has far outstripped that available to the venture capital industry. In the region there is practically no dedicated institutional venture capital available for entrepreneurs and relatively little more to SMEs generally.

[9] Ministry of Economy & Planning, KSA
[10] Egypt National Human Development Report (UNDP)
[11] Zawya, PE Monitor

The Role of the Government

However, in many industrialized countries where this issue has been acknowledged, governments have been forced to take it upon themselves to provide or encourage the provision of finance and other support to the SME segment. In the United States, for example, agencies such as the Small Business Administration ('SBA'), were created to initiate a range of initiatives such as the Small Business Investment Company program that indirectly support SMEs by channeling government funds through private sector-run investment companies and commercial banks. The existence of these well-established programs is a major factor in the ability of a government to act quickly when needed to support SMEs. For instance, to cushion the impact of the current financial crisis, the Obama administration acted to support small businesses by increasing the cap on the SBA's flagship 7(a) loan program from US$ 2 million to US$ 5 million, providing up to US$ 20 billion in new loans to the SME sector. Additionally, to make SME loans attractive to banks it was proposed that the SBA loan guarantee ratio for new loans be increased from 75% to 90%[12].

Within the MENA region, governments have also taking steps to positively impact the SME segment, but the range of responses to date have had different levels of success. Some provide capital directly to entrepreneurs, others make funds available to third party managers to invest in SMEs, others provide guarantees to banks that fund the SME segment and others offer business start-up incubation services, mentoring and advice. It would be a fair summary that to date the impact has been relatively muted as many initiatives are still at an early stage. Some initiatives are solid and well intentioned but simply lack the scale to have a major impact. For instance in Egypt, the primary loan guarantee support program for SMEs is the Social Development Fund, which has been capitalized with less than US$ 200 million and typically offers small loans of up to US$ 300 thousand, which is not sufficient for many high growth SMEs. Even in relatively well-funded countries such as Saudi Arabia, many of the programs run independently of each other and with relatively little coordination between the government and private sector.

Consequently, despite the best efforts of many governments, the SME segment continues to suffer from a lack of access to capital. Abraaj routinely receives, through its on-the-ground presence in various countries in the region, requests to invest in SMEs that are driven by a lack of available financing for growth plans. Given these dynamics, there is an attractive opportunity to fill this gap and provide much needed capital for the SME segment, in particular long-term, strategic capital for businesses with the potential for significant growth.

Reorientation of Government Support

Broadly speaking, governments in most countries in the region have adopted policies to stimulate their SME segments. At the very least there is broad acknowledgement of the fundamental importance of SMEs to the health of their respective economies and to their communities more generally. This is particularly the case with respect to governments in the region achieving their strategic objectives of diversifying their economies from commodity-based sectors and increasing employment opportunities for the region's young population, of which c. 50% is under the age of 25. Accordingly, several have gone further and have begun to look to bridge the financing gap that currently exists for regional SMEs. The chart below highlights some of the initiatives undertaken by the regional governments.

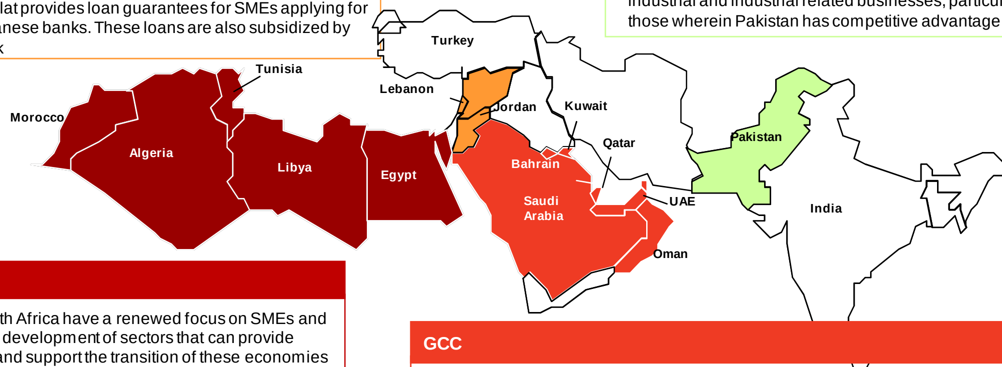
[12] US SBA, Dun & Bradstreet

Levant

- Governments in the Levant region are seeking to capitalize on their human capital base and reverse the historical 'brain drain' by ensuring that entrepreneurs have sufficient access to capital
  - Jordan – JEDCO in late stages of finalizing its initiative to seed series of SME funds
  - Palestine – recent efforts to support SMEs include SME loan guarantee scheme and a US$ 50 million private equity initiative launched by the Palestine Investment Fund.
  - Lebanon – Kafalat provides loan guarantees for SMEs applying for loans from Lebanese banks. These loans are also subsidized by the central bank

Pakistan

- The SME Development Authority has identified and is looking to support sectors with significant potential for export growth, including dairy, textiles and gems & jewelry
- The Competitiveness Support Fund (in conjunction with the Ministry of Finance and US AID) is seeking to launch US$ 250 million Pakistan industrial venture fund to support industrial and industrial related businesses, particularly those wherein Pakistan has competitive advantage



North Africa

- Governments in North Africa have a renewed focus on SMEs and are encouraging the development of sectors that can provide sustainable growth and support the transition of these economies to next stage of development (e.g. non-agriculture-based)
  - Algeria – SME Ministry seeking to create 3 million jobs by 2014 and is allocating significant funds to support development of over 200,000 SMEs
  - Egypt – Industrial Modernisation Centre increasingly focused on SME sector and has already seeded 3 third party SME private equity funds
  - Morocco – The government has recently launched initiative to provide US$ 20 million of seed funding to private equity fund targeting SMEs

GCC

- Governments in the GCC are focused on driving job creation and economic diversification by leveraging their natural advantages of location & hydrocarbons to support industries such as logistics and downstream manufacturing
- Efforts are being made to establish coordinated programs to support SMEs
  - Saudi Arabia – National Industrial Strategy will provide various support for SMEs, including potential funding for third party SME private equity funds
  - Bahrain – Government is supporting SME segment through entities including the Economic Development Board, Bahrain Development Bank and Tamkeen
  - Qatar – c. QAR 2 billion program is being planned by the Ministry of Business & Trade to support the development of the SME segment
  - Arab Fund for Social and Economic Development – Kuwait-based, recently launched US$ 2 billion initiative to provide support for SMEs across the region

It is important to note that until quite recently many of the regional governments have not had coordinated SME strategies. While many have played lip-service to the importance of the segment, the SME support programs that have been launched have been narrow in their application and many have not been coordinated with private sector participants. For instance, rather than channeling funds to SMEs through private sector institutions such as banks and local investment firms, who are best placed to recycle this money to SMEs, governments have been more interested to invest in companies directly. However, governments are generally not organized to efficiently invest in or provide the institutional support required to assist SMEs.

The less than desired impact of existing programs combined with the pressing need to catalyze the development of the SME segment has forced governments to adapt their approach. As a result, more recent efforts have focused on successful models from the West that are more akin to public-private partnerships. These programs include the establishment of loan guarantee schemes wherein governments channel subsidized funds through the existing banking infrastructure to support SMEs. Examples include loan guarantee schemes facilitated by the Overseas Private Investment Corporation (OPIC) in both Palestine, via the Palestine Investment Fund, and Turkey, via Garanti Bank. A number of governments in the region, such as in Jordan, Morocco and Egypt, have also established programs to provide seed capital for private sector run venture capital and private equity funds. Importantly, governments have been increasingly keen to consolidate their various SME initiatives under one structure. For instance in Saudi Arabia, the country's SME initiative, which currently involves non-related entities such as the Ministry of Finance and Saudi Arabian General Investment Authority, is now being consolidated under the Ministry of Commerce's National Industrial Development Program. These consolidation efforts, and the willingness to develop private-public partnerships, are the strongest signals yet of the importance that governments are placing on developing cohesive and effective SME strategies.

Beyond national governments, some multi-lateral institutions in the region have also expressed interest or more in supporting the SME segment. Notable among these are the Arab Fund for Social and Economic Development which is in the process of setting up a fund to support SMEs in the Arab region. US$ 1 billion has already been committed to this fund with Saudi Arabia and Kuwait committing US$ 500 million each.

Perhaps not surprisingly, given the geo-political importance of the region on a global basis, the initiatives of regional governments and multi-laterals have been echoed in the developmental arms of highly industrialized countries and Western political powers. Many non-regional countries have programs aimed at providing finance and other developmental support to economies within the region. The recent Call for Proposals for the Global Technology and Innovation Fund by OPIC in the United States is a case in point, drawing as it does upon the 'engagement with Muslims' theme of President Obama's speech in Cairo on the 4th of June, 2009. Investment activities by international financial institutions such as the International Finance Corporation, the European Investment Bank and PROPARCO of France have been on-going in the region for several years and are increasingly focusing on SME stimulation. Even private sector firms such as Cisco – with its "Partnership for Lebanon" program - have initiatives aimed at supporting technology growth into the region. This all adds to the real sense of 'here and now' about the opportunity.

From a venture capital perspective, it is worth noting that the ecosystem has not yet fully evolved to include a broader base of constituents such as academia and corporates in the region. There are some efforts under way to change this, including a technology commercialization development program at the Higher Colleges of Technology in the UAE and similar efforts in Jordan, these programs are relatively new and have yet to be proven out. They are also contained and not widespread across the region. However, this is expected to change going forward as there is more focus on supporting entrepreneurship and SMEs.

2. THE ABRAAJ MODEL: A TWO-TIER STRUCTURE

The approach of Abraaj in addressing the SME segment is to establish a two-tier model for it Riyada Enterprise Development ("RED") SME platform, both in terms of legal structure as well as resource deployment. In terms of legal structure, RED will comprise a region-wide investment vehicle together with a series of country-specific investment vehicles in target countries throughout the region. Third party capital will be raised at both the regional and country levels, depending on the orientation of specific investors. A benefit of this structure is in fundraising given that many host governments and other governmental and non-governmental institutions are willing to allocate capital to the SME segment on a country-specific basis. Abraaj will thus be able to accommodate such 'patriotic capital' within its overall strategy. In addition to country-dedicated capital, the structure also provides for country-dedicated resources and, more particularly, locally experienced, on-the-ground investment professionals. Each country team will be backed by the regional SME platform and indeed the entire Abraaj network, including its market leading private equity platform. Country specific vehicles have been established for Jordan, Lebanon, Palestine and Egypt.

Uniqueness of Approach

The above model is different than the traditional Abraaj private equity model, which is organized in a more centralized manner. For instance, Abraaj's larger buyout funds have been established with a regional rather than local mandate. Therefore is only one fund for the entire region, supported by a centralized investment team based primarily in Dubai. However, Abraaj firmly believes that a different approach is required to properly address the SME segment, which is local by its very nature. This means that a full time presence on the ground in each target country optimizes the day to day management of RED, whether in terms of deal sourcing, execution, portfolio support activities or otherwise. Accordingly, it is important that each country vehicle be staffed with its own investment team and self sufficient in this respect. A geographically centralized model is believed to be sub-optimal in all of these respects and probably highly risky from an investment management perspective. A properly structured two-tier approach, pooling or drawing upon additional regional resources where required, will also enable the Fund to benefit from the economies of scale enjoyed by larger funds.

By way of summary, the key benefits of the two-tier approach include the following:

Regional aspect

- Facilitate regional expansion of local companies
- Economies of scale at the fund level (e.g. junior resources)
- Ability to leverage larger base in-house, specialized resources
- Economies of scale at the portfolio level (e.g. back office)
- Ability to attract investors seeking regional exposure

Local aspect

- On-the-ground, independent investment teams with specific local market knowledge
- Maintaining ties to local business community
- Specific knowledge of intricacies of doing business in local environment
- Access to informal and formal sources of local market knowledge and business intelligence
- Ability to attract investors seeking local exposure

<u>Tailored Investment Strategy</u>

Ownership stakes

RED will take influential minority stakes, typically ranging from 20% to 50%, to ensure that the entrepreneur/management team remains fully incentivized. This also addresses certain business and cultural sensitivities in the region, with family-run businesses often reluctant to give up too much of their 'equity'. In conjunction with its investments, RED will require sufficient board representation (in many cases disproportionate to its shareholding – and usually a minimum of two seats), in order to provide the necessary level of strategic support and 'influence'. Necessarily RED will reserve veto rights on all key decisions related to the company and standard exit rights to facilitate ultimate realization of the investment. Such exit rights are more important than in traditional buy-out structures given the implicit lack of control by the minority shareholder.

Transaction sizes

Transaction sizes will vary from country to country, reflecting the size of the country vehicles. Broadly investments will range from US$500 thousand to US$ 15 million. Given the focus on acquiring influential minority stakes of between 20-50%, the average enterprise value of target companies is expected to be in the range of US$ 10-20 million, with a maximum cap of US$ 50 million and a minimum of US$ 1 million. The minimum investment size has been set at US$ 500 thousand in order to remain opportunistic in some of the smaller or technology focused markets (e.g. Palestine, Jordan, Lebanon, Oman).

Investment structures

Investments may be made through a variety of instruments, including ordinary equity, preferred equity, mezzanine debt and convertible/hybrid debt as appropriate. There will need to be a core tranche of true equity share capital and the use of additional instruments will depend on the nature of the target business, its financing requirements and cash generating capability. Given the varying needs of SMEs in the region, RED will necessarily need to have flexible mandate in this regard.

Differences from the US model

It is important to note that when discussing the SME segment and venture capital opportunities in the MENA region, the focus is much more on traditional industries than the development of new technologies. The US venture capital model is, to some degree, based on the latter wherein a portfolio of 10 investments will have 1-2 mega-hits and make up for failed investments in the portfolio. Kleiner Perkins' investment in Google was one such example, wherein its c. US$ 20 million investment generated close to c. US$ 18 billion in distributions and generated substantial returns for investors in a fund that otherwise was suffering. However, in the MENA region there have not been cases of technology-based business models generating these Google-like returns. Nevertheless, there are an increasing number of venture capital businesses that are being established to take advantage of the proliferation of the internet in the Arab world. Some of these have provided early success stories. One example is Maktoob, the region's first on-line portals and a company in which Abraaj was an early stage investor; Maktoob was eventually acquired by Yahoo! which is actively seeking to expand its presence in the Arab world, along with Google and Microsoft. While technology-based investments have to date been rare (although increasing in number) there remain a number of venture-like investment opportunities in traditional industries. Such opportunities present attractive risk-reward based investments. Examples include entrepreneurs in the region who are creating innovative business models in traditional industries such as healthcare and education, sectors that have traditionally been government-run but that are increasingly being open to the private sector as governments seek to reduce their fiscal burdens, attract private sector investment and improve the quality of service. Generally, successful models from developed markets can be employed and customized to the MENA region. In these types of businesses, the focus is often more on execution and backing strong management teams than it is on creating new business ideas.

3. PARTNERING WITH GOVERNMENTS

The development of Abraaj's SME platform is, by its nature, closely tied to the strategic goal of governments in the region to boost support for the SME segment (as discussed earlier). Accordingly, Abraaj has been working closely with regional governments with respect to establishing the RED platform. Examples include Palestine, Jordan and Egypt, where Abraaj has established its fund in conjunction with various government ministries that are keen to support the development of SMEs in specific industries, including the Industrial Modernization Center in Egypt, the Palestine Investment Fund and the Jordan Enterprise Development Corporation. Discussions are also taking place with a number of other governments with regards to establishing a dedicated SME investment vehicle for their country. In addition to regional governments, Abraaj has also been working closely with a number of DFIs and multi-lateral organizations whose goal is to support economic development in various countries in the region. These include entities such as OPIC, the IFC, European Investment Bank and others. To date, there has been significant momentum created through these conversations, with some of these entities serving as cornerstone investors in the RED regional and country investment vehicles. The high level of interest shown by these governments has been an important factor in the successful establishment of RED.

In addition to its investment platform, Abraaj has also engaged governments in the region with regards to various corporate social responsibility initiatives that are also tied to the SME segment. Chief among these has been the creation of a dedicated on-line portal to support SMEs and entrepreneurship in the region. Abraaj has been working over the past several months on this portal, which will provide for free content for entrepreneurs including legal advice, information on countries and sector opportunities and videos including interviews with a number of the region's leading entrepreneurs. Importantly, a number of government entities in the region as well as leading corporate entities (including technology companies, law firms and other service providers) have joined Abraaj in supporting this venture as cornerstone sponsors and providing free content in this respect.

4. LESSONS LEARNT AND RECOMMENDATIONS

In developing its RED platform, the following lessons have been learned:

- The ecosystem for SMEs in the MENA region is still in a developmental stage. Although governments are keen to support this segment, the success of their programs to date has been mixed and their approach is now changing to support more private sector involvement. Also, there has been limited involvement to date from academia and corporates in supporting this sector. Bank lending to this sector is also weak, with SMEs accounting for only 8% of the loan portfolios of banks in the region. Therefore, investors need to take into account the relatively weak ecosystem.
- The SME segment in the region is a very local market, especially given the region itself is heterogeneous from the Levant, to North Africa to GCC, Turkey and South Asia. Therefore a local approach is required and it is extremely difficult to address the SME segment on a centralized basis (e.g. from Dubai).
- A tailored investment strategy is required to address the SME segment. Given that most SMEs in the region are first/second generation family businesses, the opportunities for buyouts in this segment are limited. Therefore, a more growth capital oriented approach is required wherein investors must be comfortable taking minority stakes in these enterprises. This issue can be overcome through structured shareholder agreements, but more importantly it is important to develop a strong relationship and level of trust with the counterparty (i.e. entrepreneur).
- The investment opportunities can be classified more as venture capital investments in traditional industries rather than technology-based investments. Despite the lack of opportunities to generate Google-like returns, there are extremely attractive investment opportunities on a risk-adjusted basis in the SME segment in the MENA region.

- In terms of investment themes, many of the entrepreneurs in the region are seeking 'smart' capital to help institutionalize their businesses and expand past their local markets. Therefore, a private equity firm that has a track record in this respect and a regional network can add immediate value to these entrepreneurs, who are looking for strategic support as much as growth capital. However, one would need to be careful that they are investing in a strong management team that will not require too much hand holding and for whom it will be sufficient to provide strategic-level support.
- There is significant pent-up support for SMEs in the region, from governments, multi-lateral institutions and corporates in the region. Leveraging these strategic partners can provide critical support for firms seeking to invest in this segment.