REGIONAL TRENDS IN A CHANGING GLOBAL ENVIRONMENT

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SESSION ONE: **M&A ACTIVITY IN THE MIDDLE EAST**

Speakers around the table

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SESSION ONE: M&A ACTIVITY IN THE MIDDLE EAST
LIQUIDITY AND VALUATIONS ISSUES

Charles Fuller (CF)
It will not come as a surprise to anyone that, in these times, a lot of the challenges being faced in the Middle East are the same being faced the world over. In terms of getting a buyer and seller to even speak together, we’re facing quite substantial valuation gaps, with the seller’s expectations still being somewhere in the past compared to the buyer who is trying to pitch their price near the bottom of the market.

As a result, buyers and sellers must now be a little more creative in trying to bridge both liquidity and valuation gaps. It’s an interesting trend, especially in relation to larger deals that have been run by way of auction, as has happened traditionally. I’ve watched incredibly well-managed auction processes just collapse because the valuation has not been met, and the leverage isn’t there. What starts to emerge are bespoke bilateral deals between buyers and sellers, where, for instance, there may be earn-outs, vendor notes, or a requirement for the vendor to retain an equity interest. This can all help get over the initial liquidity problem, and ensures that the vendor has invested in the future performance of the company as well.

Ziad Makhzoumi (ZM)
ZM: The two major issues at the moment are the availability of funds and valuations. However, there are some ways around the financing issue. If you’re a listed company you can probably use your shares; you can borrow; you can syndicate; you can have convertibles - there are many different ways of doing things. We have also looked at whether there are ways of providing equity through an earn-out: we would buy something, possibly raise funds to pay 10% to 30%, then add some cash from our side and pay the rest over a period of time if the numbers add up.

In terms of valuations, we looked at an acquisition last year that was valued at a specific price that would not even be remotely realistic today. The banks were ready to fund 100% of that acquisition. I don’t believe they would fund even 30% of that deal now, even at the reduced value. This is the challenge that we are facing, but there is also the issue of whether the seller is ready to sell at a given price? And why are they selling? Currently there are two kinds of vendors: those that have no choice but to sell because they were caught up in the tough business cycle, and sellers who want to sell, but who are not in a hurry - these are the difficult ones to do a deal with at this stage.

Azmat Taufique (AT)
AT: Certainly, in the last few months we have found that sellers who were not returning our calls just a year ago are more willing to sit down and talk.

As for financing, this is also an issue but the market opportunities of the region are not wholly about leverage. Yes, leverage is needed, but the real opportunity in our region is growth. So, if you are looking at businesses that have fundamentally good growth prospects, and if leverage is something that you might be able to get as icing on the cake, then you are certainly looking at a good business opportunity.

Nikhil Sengupta (NS)
NS: Some of the changes that we’re seeing are good companies with good businesses that require funding: either for growth, or because banks are knocking at their door demanding repayments. Among the themes that people today have been talking about, there are probably two key trains of thought. One is that we are faced with a very deep crisis of confidence, and the second is a lack, and possibly even a crisis, of liquidity. Bank financing is constrained, but perhaps there was too much of it available in the not-too-distant past. However, there are pockets of equity with some private equity investors and even some corporates are currently looking at making new investments.

Another one of the ways that the lack of liquidity is being addressed is the consortium approach; two or three investors coming in together to make an investment. Most recently, Investcorp has used this structure; in fact we’re working on a few such opportunities right now. These types of investments might be primarily led by a strategic or financial partner, but one that is looking for other financial partners to come along.
This year we’ve seen a relatively small volume of M&A deals in the GCC region and valuations have gone down to perhaps a quarter or a third of what they were even 12 months ago. Sellers are slowly changing their expectations and have gradually started moving from wanting to sell assets only at a very high price, or even not wanting to sell assets at all, to realising that they may need to make divestments out of necessity. Initially, they may only want to sell poorly performing or non-core assets, but they are realising that perhaps they need to sell strong assets in order to attract investors. And whereas 9 to 12 months ago they were looking to sell at stratospheric valuations, price expectations are slowly beginning to align.

That said, people everywhere are now faced with the question of what the shape of the recovery will be. Gone are the days when people were expecting a V-shaped recovery, or even perhaps a U-shaped recovery. Everyone’s looking now at a potential W-shaped or L-shaped scenario, which is a really key issue. As such, people with a longer-term outlook are the ones making the investments. A lot of financial investors who have a shorter-term view are really still sitting on the sidelines, waiting for a few months to see what happens, because their exit options are going to be limited in the near- to medium-term. The strategic investors are on the lookout, and that’s perhaps a bit of a change from six months ago. So, in this respect, there has been a small observable change in market sentiment over the past couple of months.

Masood Razaq (MR)

MR: Global and regional developments have meant that many businesses have not performed to business forecasts. Now we’re seeing a change with numerous companies seeking liquidity to achieve their growth plans and manage this uncertain period. We are seeing a lot more business raising capital and, as a buyer, we feel more comfortable putting money into companies, rather than giving the seller a big payday in a large liquidity event. From a strategic perspective, there are a lot of cash-rich companies saying: ‘We have an advantage, and we might be able to acquire competitors; build complementary businesses; launch new products and services,’ while their competitors are relatively weak, or distracted with restructuring.

AT: Due to the lack of liquidity, consortiums are also coming together to broker deals. We recently did a deal where we brought together a consortium to take control of a company. It is not easy due to the complexity of the transaction, whether it’s an auction or a private process, particularly when multiple parties are involved. However, if you manage to align the objectives and align the process then it can have tremendous benefits; you may be able to grow in an industry that is at a fairly early stage of development, or you could build relationships that could be extremely useful in your next transaction. More pertinently, in an environment where information is very difficult and where relationships are very important, a consortium can bring a massive amount of resources to the due diligence process. So, if you can harness the consortium approach, and align resources in such a way that people are pulling in the same direction, it can be a very powerful way to get deals done.

DUE DILIGENCE

ZM: The issue of due diligence is an important challenge for doing deals in our region. Availability of information is not always clear and we have been involved in certain due diligence processes where it has been interesting, amusing and, in some cases, sad what people try to show you and convince you is truth. It is very difficult to get precise, clear, verifiable data in a timely manner. However, our view is that if a company wants to do a deal, we can look at doing a deal. We’ll take the risk that they are telling us the truth with regards to information about the company, and they will take a risk on the valuation. These are the challenges that I believe we are going to continue seeing.

AT: The markets in the Middle East and North Africa are much more similar in their fundamental institutional frameworks and economic situations than to the developed markets of Europe and North America. Of course there are cultural differences, and there are some social and historical differences across the Middle East and North Africa, but fundamentally the challenges are very similar. You have the challenge of inefficient information, as sometimes information that is provided to us by the vendors, or their advisers, is incomplete and very often unreliable. You have to be careful during the due diligence process and retain an element of scepticism over what is being provided to you. With all respect to the accounting firms, even the Big Four available here, it is often the case that you cannot trust the data or the audited accounts that are provided to you blindly: some of them are going to be fine, but often they’re not; so you have to dig a lot deeper into the fundamentals of the company. That’s the biggest challenge in this region.
in this way, you can move away from the short-term lack of clarity private equity buyers certainly do, is to look at the medium- to long-term. However, what I like to do, and I think strategic acquirers and a lot of Acquirers are also switching their buying to so-called defensive sectors: spending, there is no doubt that areas such as luxury goods are exposed. this quarter, or this year. There's a huge focus right now on what could your purchasing decision based on what the impetus is of today, or what you really need to do is take a longer-term view and not govern panels and discuss the year's big trends. Last year, we were talking Construction sector where they have already declined sharply.

There are different M&A drivers in different sectors. One is certainly the government and this is more applicable in the Financial Services sector, although it is very likely to happen in the Real Estate sector as well. Other than that we're hearing a recurring theme now of people wanting to invest more defensively. Social infrastructure is becoming a big buzzword in this regard, and by that I mean things like Healthcare, Education – niches which are essentially recession-proof. I think the FMCG sector is actually going to be more resilient, although the Industrial sector remains exposed. Valuations are going to be heavily impacted in the Construction sector where they have already declined sharply.

Sometimes it is helpful to step back. Every year we can have these panels and discuss the year’s big trends. Last year, we were talking about agriculture and commodity prices being too high. As a buyer, what you really need to do is take a longer-term view and not govern your purchasing decision based on what the impetus is of today, or this quarter, or this year. There’s a huge focus right now on what could be relatively over-valued and with people cutting back discretionary spending, there is no doubt that areas such as luxury goods are exposed. Acquirers are also switching their buying to so-called defensive sectors: Healthcare, Education and the low end of the Consumer market. however, what I like to do, and I think strategic acquirers and a lot of private equity buyers certainly do, is to look at the medium- to long-term. In this way, you can move away from the short-term lack of clarity and predictability.

The long-term is much easier to predict. For instance, one key driver of M&A is that you can comfortably predict demographic trends. Demographic trends don’t change suddenly and drastically. We know that Italy, Japan and Russia are going to be much smaller countries in terms of population by 2030 than they are today. These are countries with low population growth rates so there’s a natural logic to look at things that the ageing segment of the population needs, for example, healthcare, medical devices and nursing homes. Alternatively, in this region and in emerging markets more broadly, there are very young populations. There are a lot of countries where 50% of the population is under the age of 25 and you can model out, with a fair degree of accuracy, how households are likely to evolve by looking at the longer term demographic trends. So, investors will be looking to these countries for growth in areas such as Consumer Products, Financial Services and Telecommunications. We know what the birth rates are, what the age segments are and how it’s going to evolve, and you can pretty safely predict that there’s going to be more consumption.

There is a fundamental imperative to consolidate in the region across all sectors, except for perhaps the primary Oil, Gas and Petrochemical sector. However, if you look at almost any industry in the region, there will be many businesses, including the Financial Services sector, that operate sub-scale. In part, this is because of restrictive laws and regulations, but cultural and social factors can also play a role. If you look at economic trends, there are opportunities for consolidation, although whether this is actually going to happen is open to debate. Frankly, five years ago many people, including myself, were arguing that there should be consolidation in the Financial Services sector. Apart from Emirates NBD, this has clearly not happened. But there is an opportunity cost of not doing M&A and I think it will happen at some point in the next three, four or five years.

With regard to IPOs, from a private equity perspective, if you invest in businesses that are fundamentally growth driven and you have the ability to create scale and efficiency in the business, then the opportunity to create liquidity will come. There will be economic cycles, and of course right now, we are going through a very challenging time for IPOs. But there will be a turn in the cycle, and there will be opportunities when you will be able to create liquidity for your investment over the next few years. IPOs are not always necessarily the most efficient way to create value for your investment. Sometimes strategic buyers can provide a better exit route for investors. Therefore, we keep our options open and we obviously have a Plan A, B and C. If you’re asking whether or not the IPO market will come back, I would say yes, absolutely.

The only public offerings we’re seeing now in the GCC region are IPOs of around $10m to $20m, which are mostly happening in Saudi Arabia. There’s one large deal in Qatar. Interestingly, there are some very large banks leading those small transactions, which shows the shift in terms of mindset and the sort of transactions banks are being forced to chase now.
Family Businesses

MR: Firstly, family businesses are very important to the private sector in any country, whether it's the US, UK, other G-7 countries or emerging markets. In emerging markets they tend to play an even greater role and this is true in the Middle East. As such, what they do as a business and how they think about the world, opportunities and challenges is pretty important overall.

There are a couple of mindset-type issues where family businesses differ drastically from corporations that are either publicly held, or where there are many other stakeholders other than family members. The first major difference relates to the transparency of family businesses. The fact is that a lot of people don’t really know what’s going on in the boardrooms of family companies, because they are not privy to those conversations. The most likely people to have insights on these types of discussions are very trusted advisers or corporate bankers who are lending to these companies. In general, however, private companies are called private for a reason and therefore it’s less clear what sorts of challenges they are facing.

However, there are a couple of things that we can discern just by observing behaviour. First, family businesses tend to have a totally different perspective on what makes a good business, a good opportunity and what one should do when faced with challenges. If you’re a public company, or you have multiple shareholders, you have quarterly pressure to deliver earnings and to deliver growth targets. For family businesses, if there is internal harmony and governance, the family CEO is the last guy to get fired from his own business. Obviously he will have a different perspective on hitting internal targets. There may not be a huge impact on the family if the business does not perform over a short time period, perhaps they may dividend out less or scale back investment plans. There is no real market-driven stress the family would feel.

“A LOT OF FINANCIAL INVESTORS WHO HAVE A SHORTER-TERM VIEW ARE REALLY STILL SITTING ON THE SIDELINES, WAITING FOR A FEW MONTHS TO SEE WHAT HAPPENS, BECAUSE THEIR EXIT OPTIONS ARE GOING TO BE LIMITED IN THE NEAR-TO MEDIUM-TERM.”

Nikhil Sengupta
While CEOs feel as if a big clock is operating over their head, family businesses look at time from a very different perspective: not one-year, three-year or five-year plans, but from a much longer perspective. The time horizon is often multi-generational, which is a totally different mindset than a CEO or large corporate would have. You see businesses that started with very humble origins, which come 30 to 40 years later are multi-billion dollar businesses.

There may be certain sectors that are more strategic for a family to be in over a longer period of time. Even though a lot of family businesses are run very professionally, the decision-making process and general business, especially in difficult trading times, is very different. Lastly, a lot of family businesses are very conservative in their capital structures. Some of the large multi-100 million or even billion dollar companies have almost no debt whatsoever and in this market a lot of them are looking at this as a really prime time to be looking to undertake M&A.

AT: Most family businesses are properly organised and forward-looking with the added advantage that the board of directors can make decisions very quickly. The board of directors are the owners of the company and can make decisions prudently, conservatively, aggressively or however they may want. That is a very important difference between family businesses and corporations. The ones who have taken the step of structuring themselves as a corporation, putting in place CFOs, have taken that step of moving from being a mini-club where occasionally people go and discuss things to having a proper organisation.

CF: The other interesting thing about many family businesses in the region is, whilst a lot of them were originally property-based and therefore one would assume that they might be suffering at the moment, the diversification of these family businesses across a broad range of sectors has probably helped to support them. However, when family businesses look to take the next step and either sell or seek external investment with a view to expanding across the region, they face key challenges. By definition family businesses are very private and they don’t necessarily want to share information and give away the degree of control that overseas investors would be looking for, especially in current conditions where people are very risk averse.

REGULATORY ISSUES

CF: The lack of bankruptcy laws has meant that we don’t have the same sort of restructuring transactions that have dominated the markets in Europe and the US. In the Middle East there simply isn’t the threat that the company will go into bankruptcy if a deal isn’t cut, which is something that I think is an area that will evolve in this region. There are moves to try to address these situations, which may help the market mature into the sort of market that we are familiar with in parts of Europe and the US.

ZM: With respect to the issue of regulation that Charles raised, each market in the GCC has different regulations, and it’s not easy to use the same standards or even to guarantee that things are done in a certain way across the different regional markets. For example, certain assets are not properly registered, there has to be some clarity and tidying up of issues such as these before any further steps are taken.

AT: In terms of private equity, there are ownership restrictions that do not allow such investors to become control owners in companies. So again, you need to overcome these structural and institutional drawbacks, although there are enough opportunities in this region, that if you are persistent and diligent, then deals can get done. There is no better time than I have seen in the last six, seven years, than today, to make good deals in the region.

CROSS-BORDER TRANSACTIONS

CF: If you get beyond the financing and valuation gap hurdles, due diligence has become a more difficult process and this is magnified with cross-border deals. Obviously, when buyers are doing deals in foreign territories, they will encounter regulations with which they’re unfamiliar. In this region there are a lot of challenges related to ownership restrictions, which vary from country to country. Bidders can be put off by this. As a result, we are facing difficulties at many levels and this is hampering deal activity.

ZM: As is the case in any transaction in today’s market, the biggest challenge for cross-border M&A deals is leverage. It’s simply not there in most developed markets. The second challenge is that most businesses acquired in the last three to five years, and most of those operating in more developed markets, are going through major earnings challenges. From a private equity perspective, there are opportunities in the publicly listed markets in Europe as valuations have fallen markedly over the last 12 months. At that time, we simply did not bid for some companies because they were, in our mind at that time, over-priced, but today they look very attractive. If you are able to overcome the leverage issue, there are very interesting cross-border M&A opportunities in these markets. This is especially the case if the acquirer’s able to identify businesses that can go beyond their immediate geographic scope and create some kind of bridge to other markets.
SESSION TWO: PRIVATE EQUITY IN THE MIDDLE EAST

Speakers around the table

Umar Saleem
Senior Director
Alvarez & Marsal

Rehan Samee
Head of Leverage Finance & High Yield Investments
Emirates NBD

Vikas Papriwal
Partner
KPMG

Tim Ross
Finance and Restructuring
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Abrar Mir
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NBD Sana Capital
SESSION TWO: PRIVATE EQUITY IN THE MIDDLE EAST

PRIVATE EQUITY FORECASTS

Abrar Mir (AM)

The main challenge facing the regional private equity industry looking forward simply is: what is going to be the length and depth of this economic slowdown? We probably all agree that the type of turnaround we’re expecting is probably not the trampoline-type economics that people in the US, for instance, have talked about in the past. We are probably going to see a more gradual recovery coming throughout the course of this year.

With this gradual recovery, I foresee that the regional private equity community will witness four key changes. The first is on the regulatory front. Private equity firms located in the region, particularly Dubai, have a big lead on many of our emerging market peers, because of the presence of solid regulation, for instance, by the DIFC. This regulation is clearly going to increase and that’s a positive even though many private equity firms have been resisting.

As a result of this, the second key change that we’re going to see, both regionally and globally, is greater transparency. The veil of secrecy will be lifted and there will probably be greater demand for private equity to be as transparent as publicly-listed corporates. The third key change is that leverage will not play as important a part as it has in the past in terms of generating economic returns for private equity. Fourth, I think the key driver will shift towards value creation instead of having the luxury of generating returns through the repayment of debt.

As a consequence of these changes, we’re probably going to see increased consolidation, even amongst the private equity players that we see around today. Furthermore, we will see that consolidation in probably two different ways. We will see forced sales and at the other end of the scale, there will be potential consolidations among private equity firms that want to bring together the underlying logic of co-investments, as well as some of the underlying skill sets that are actually needed to be a long-term successful player in this space.

Tim Ross (TR)

TR: In the future, we’re going to see more active LP involvement, with smaller groups of investors supporting individual funds. It’s a return to a much more active LP management model. This is a more difficult model for GPs as it takes more of their effort to manage the LPs.

The other thing that could occur in the near-term is that there are a lot of very good companies out there which are owned by funds, and some of the funds themselves are struggling. These companies are looking for more support from their owners than they’re currently getting. Some of those management teams could be in a very strong position in terms of cutting the next deal for themselves.

Vikas Papriwal (VP)

VP: What we’re basically seeing nowadays are private equity houses doing a number of things aside from making new investments. Sponsors are increasing equity stakes in some of their portfolio companies and there’s much more operational improvement. We’ve seen a lot more work around work-outs which typically involve releasing cash out of the business as well as reducing costs.

There will also be greater focus on increasing EBITDAs by actually doing something with the business as opposed to letting the market do the work. The other interesting thing that is going to happen is the way exits are going to pan out. Going forward, the market will see more trade and financial sales as opposed to IPOs. Holding timelines are going to increase, so people who invested with a two or three year time horizon are reevaluating those business plans and seeing how they can hold the business together for two more years. Nonetheless, I think a lot of private equity forecasts look relatively positive. One thing that is fairly certain, is that the FY 09 vintage funds are going to have good returns, especially where valuations are right now.
Umar Saleem (US)

US: What we are seeing is that due diligence processes that are currently being done are actually being read, and the investments that are being made are more thoughtful and more strategic. Investors are spending more time in the pre-acquisition phase, focusing on operational improvements and identifying hidden values. Exit periods will go up, as it takes longer than 24 months to turn around an organisation and make a notable profit out of it. Furthermore, I think that LPs are now getting actively involved in looking at the kinds of steps that are being taken by the GPs to make sure that they are getting a good return on their investments.

Overall, I think the industry is moving into a more mature cycle. People are taking a longer time to look at investments and I’ve seen cases where people have actually walked away from potential investments, and that is a healthy sign in the market. Earlier on, if you had a very interesting proposition it would be very difficult not to place that bet.

Rehan Samee (RS)

RS: I completely agree that the industry will change. What we saw between 2006 and 2008 was this mad rush insofar as whoever was promoting a fund, people would flock to it. I think that’s going to stop and it’s going to be very selective from here on in. Gestation periods are going to be longer, the success measures are going to be driven by how intelligently the GPs manage their portfolios and extract value from them over the medium term.

DEAL FINANCING METHODS AND VALUATIONS

AM: In the current economic environment, one of the most important considerations that private equity firms have to think about is how declining portfolio company performance impacts the underlying value of their investment. It comes down to a question of both valuation and visibility. Valuations are only a function of the earnings that you can actually derive from the initial investment. Therefore, for us, the critical challenge right now is not just getting the right valuations, but much more about studying the visibility and the predictability of earnings going forward.
Moving over to the issue of leverage, I think that some firms will still be able to capitalise on this, although it will be extremely selective. Many of the financial institutions that were very active just a year ago have been impacted by the economic slowdown. Their own balance sheets have been negatively impacted.

Secondly, the region historically has not been generally comfortable with non-recourse financing, and going forward this is only likely to be available for robust corporates. In their mandates, private equity firms don’t allow for recourse lending. Therefore, even if dry powder does exist, it becomes a challenge for private equity firms that are pure financial sponsors to be able to actually access that firepower in the leverage markets.

**RS:** Elaborating on Abrar’s point about with non-recourse lending being only available to solid regional corporates, we should remember that the CFO of Arabtec mentioned recently that leverage has been made available to them. Arabtec is a big concern and on this basis it would appear that banks are lending, but only on a very selective basis.

This selectivity is mainly due to a couple of factors with lax disclosure norms being one issue. The second factor revolves around the risk architecture that banks have in this region. I’ve been here for 12 years and things have changed a lot in the period, but the risk architecture is not the same as you would find in a global bank with great emphasis being placed on name lending in this region. At the same time, security perfection is a challenge and this adds to that difficult credit decision that risk managers have to make, or perhaps shy away from.

Nonetheless, the lack of non-recourse lending has meant that some financial sponsors in the region approach transactions with an expectation that their equity will not be leveraged. Alternatively, they approach transactions differently in the sense that they look at the debt capacity of the target that they’re acquiring and don’t seek excessive leverage and I think this is a good thing.

**TR:** From a funding perspective, regional strategic players probably have a bit of an advantage over private equity players. A lot of the lenders who previously lent to private equity are no longer in that business at all - RBS being a very notable example. Indeed, the whole bank funding system relied so heavily upon the originating banks’ ability to sell the paper out into market and this just can’t be done at the moment.
ISLAMIC FINANCE

AM: NBD Sana Capital is a Sharia-compliant firm and more generally we are seeing a willingness to participate, accommodate and actually facilitate Islamic financing on a global basis. Historically at least, Islamic financing has been very strong in the Far East and it has taken on a very significant role in both corporate and private equity financings. For instance, Turkey has historically been a somewhat secular country, where Islamic-type institutions were not especially encouraged. Now, the mindset has changed amongst institutions there in order to allow for this type of financing, and this has meant that some of the underlying fundamentals are actually pretty positive – we see that as a big driver for the continued growth of Islamic finance going forward.

RS: Shariah-compliant acquisition financing structures are still very rare. I can only think of one transaction where a Sharia-compliant structure was used in an LBO and that was the acquisition of Aston Martin by a consortium of regional investors. However, this doesn’t mean that this particular type of deal financing isn’t popular. I think for very emotive reasons, there is a lot of demand for Sharia-compliant financing and banking, therefore, you find such institutions being very liquid. Liquidity is one thing, but there has to be the ability to analyse risk and structure something tailored to that risk. In summary, it’s a very liquid market which has grown but it remains small by global standards.

TR: From a legal perspective, I think it’s a very interesting time right now for Islamic finance. I think a lot of the Sharia-compliant financings that are in the market are being tested legally for the first time, including in the UK. This is a positive development. However, many Islamic financings are bespoke and this means that the lessons from these early cases may not apply broadly. Nonetheless, it’s a positive sign, and there are some very good innovations that we’re observing.

US: By nature, Islamic financing is very conservative, and that’s why in today’s economic climate, people are looking more towards Sharia-compliant products and offerings. In addition, the region is fairly liquid, a good example of which is the wind-up of Lehman Brothers, which we are currently managing. We hold about $42bn of Lehman real estate across the globe and are currently handling enquiries from regional investors, so if anyone comes to me and says that there is no liquidity, I would disagree. While the Sharia-compliant market stands at around $700-$800bn, miniscule by global standards, Sharia-compliant products are definitely being looked at as they are very conservative in their lending policies, as well as being fairly liquid.
CURRENT INVESTMENT CHALLENGES

AM: One of the other big challenges facing the industry is the state of current portfolio companies. The private equity firms which invested at the height of the buyout boom are now spending much more time with their portfolio businesses, the result of which is that they are not investing elsewhere at the moment.

However, where there aren’t these issues, the current market turbulence and uncertainty creates opportunity. We still think pockets of the economy are well positioned in this region, such as the Consumer and Retail spaces as well as the Healthcare and Telecoms sectors. Private equity firms that were not active in 2007/2008 will actually be much better positioned and probably much more active in accessing opportunities in these sectors.

We also have to consider what is going to happen to the industry’s LPs. They will certainly be thinking very hard about their own liquidity situation at the moment. The shift in the equity markets would have impacted on their asset allocation models which had been put in place before the credit crisis. As a result, many institutional investors may feel that they are over exposed to the private equity asset class. However, not all LPs are struggling. Indeed, some of them are increasingly looking to access the secondary market, either to get into transactions, or to get into funds, either way at a discount to market prices, which could benefit private equity.

TR: We have found that many private equity firms are indeed embroiled with such concerns and they’re working through them right now. They try to retain their focus but at the same time they are very busy fixing their portfolio companies and spending a lot of time on investor relations.

US: In the current economic climate, local private equity firms need to ensure their portfolio companies are preserving cash and improving their working capital positions. And as private equity becomes more inward looking, exit timeframes will increase significantly.

VP: There is a lot of talk around the regulation of the private equity industry at the moment. In the UK there is the Walker Committee which has made recommendations regarding the transparency of funds, while there are also the Santiago principles. When we were talking with clients six months ago, I think there was not much interest in these, but I think GPs now are much more likely to be looking at transparency issues. The better managed funds are beginning to look more at corporate governance and transparency which obviously adds a certain cachet to the industry.

RESTRUCTURING

AM: I’d just like to add that one of the challenges facing restructurings here is the lack of robust bankruptcy rules. In addition, investment mandates precluding buyout firms from investing in distressed public markets is something that we’ve certainly spent some time thinking very hard about. However, we don’t necessarily agree with the economic argument that the real opportunity is currently only in the distressed space. We still continue to believe very strongly that the underlying fundamentals of the private equity market are strong, despite the economic turmoil.

I think that there are also challenges facing investors in regional distressed markets. The challenges are primarily regulatory in nature, such as the opacity of rulings allowing large financial sponsors to take meaningful stakes in stressed public entities. A few jurisdictions do not allow this unless bidders make a mandatory offer at a relatively low threshold for the entire company. In these instances, you really have to undertake a take-private just to participate in an existing public entity.

PRIVATE EQUITY REGULATION

TR: There are definitely some encouraging signs for regional regulatory changes which will bring about a more favourable environment for private equity transactions. For example, in Doha there are some regulatory advances being made to allow for Sharia-compliant funds to be established. The DIFC also now has its new special-purpose company arrangements, so there is some regulatory evolution going on that should facilitate fund formation and operation.
"MOST CEOs HAVE STRATEGIES FOR THE GOOD TIMES, BUT NOT FOR WHEN PERFORMANCE IS DISAPPOINTING. WHEN A BUSINESS PLAN STARTS TO FAIL, THEN A CEO NEEDS TO LOOK INWARDS AND SEE HOW THEY CAN IMPROVE PERFORMANCE."

Umar Saleem

In addition, we’re involved in a significant initiative in regional bankruptcy and insolvency regimes. Hawkama, the corporate governance institute of the DIFC, is centrally involved and has been working with the World Bank and others on a survey of MENA bankruptcy and insolvency regimes. However, the result of that project will only be seen over the mid-term.

There are a number of other initiatives out there, but the pace of legal and regulatory reform tends to be pretty slow.

AM: I certainly have not seen any instances of regulators proactively taking steps to inhibit situations or investments, and I do not think that they would adopt such an approach. On the contrary, I think regulators in general have been proactive in trying to understand what those hurdles are and trying to create a framework or at least a pathway for those investments to occur.

From a risk perspective, investors still need to operate within the rules of engagement. For instance, in Turkey, we see huge opportunities in the distressed public markets space, there are companies trading below not just historic levels, but even below their cash value. However, rules around a forced minority sale or a squeeze-out simply don’t exist, so it is virtually impossible to take a company private in that context. No matter how the regulator can help you, the underlying rules and regulations just need time to evolve and create a safe environment for a private equity investor to undertake those types of take-private transactions.

What I do think will happen is that private equity firms will not engage in full take-private transactions in certain jurisdictions until the regulatory framework there is more developed. Until such a point, private equity firms will probably just take more meaningful stakes in some of these public entities. Ultimately, regulatory reform is a gradual process and I do think it will take a little time to create the certainty that the industry really needs.

UNCALLED COMMITMENTS

RS: As far as leverage financing is concerned, financial sponsors are sitting on a lot of dry powder with estimates ranging from anything between $10-$15 billion in uncalled commitments. And the fact that this was not deployed at the height of the cycle is perhaps for the better. The question however, is not solely around valuations, but more about the confidence and the visibility of earnings going forward. I think there is a lack of confidence and a general sense of nervousness amongst investors to broker deals in the current environment.
VP: I also agree that there’s about $11-12bn worth of dry powder out there. However, I think the big question is how much of that is actually being spent in today’s market? We are seeing LPs getting directly involved in investment decision making and bolt-on acquisition opportunities, which is very interesting. Otherwise, there’s going to be much more equity financing on these deals. Leverage across the world is going to be a rare commodity, especially with the current preponderance of state-owned financial institutions. You’re going to see leverage going out of deals more and more in the future.

TR: We’re somewhat surprised by the amount of fundraising that we’re seeing out there. There seems to be a significant amount of fundraising and fund creation going on. I’m rather surprised that people are so bullish. Maybe I should be a little more optimistic. There is a huge amount of cash on the sidelines and that capital is going to make its way back into the economy eventually. The big question is: to what extent does it get back into the economy through private equity? I think the prognosis is good if the industry’s tendency for loading up good companies with too much debt will decrease.
POST-CRUNCH PRIVATE EQUITY TRENDS IN THE MENA REGION

OVERVIEW
Many funds that have raised their money in the last two years are looking closely to invest but are waiting for the moment when valuations are realistic to them. In the secondary market also, much is being evaluated, but little is transacting. However, as the economic situation begins to stabilise and liquidity pressure on businesses and LPs increases, the bid-ask spread is expected to narrow in both the primary and secondary markets and funds with significant levels of dry powder are expected to reap significant returns from FY 2009 and FY 2010 vintages. In tandem with low valuations, the investments made in the coming months are likely to be more thoughtful, as PE firms spend more time sourcing deals and creating value than raising new funds. Although the private equity industry has been rightfully cautious during the last year, many see the current situation as a unique opportunity to make excellent returns without over-leveraging. In addition, the economic fundamentals of most MENA countries remain robust and are supported by strong fiscal policies and trickle down from rich government reserves. International investors will continue to be attracted to the region and defensive industries, in particular, will be popular and profitable investments in the medium term. Egypt, Saudia Arabia and the UAE will remain as the focus of investment inflow and it is likely that Sharia-compliant structures will play an increasing role.

OPPORTUNITIES FOR FUNDS WITH SIGNIFICANT LEVELS OF DRY POWDER
During 2007 and 2008, fundraisings increased, with the average fund size in 2008 being $258 million (2007: $213 million; 2006: $177 million). However, the number and size of investments decreased in 2008 and funds have found it increasingly difficult to deploy capital. This has led to an accumulation of uncalled capital, or so called ‘dry powder’.

In late 2008 and the beginning of 2009, some sellers found it difficult to make the psychological leap down from the highs of 2006-2008 valuations but while credit conditions remain tight and capital raising through the equity and debt markets less realistic, private equity may become a preferred method of financing for many firms in the region. Although transaction volumes are still low, there is optimism among analysts that reduced valuations and this scarcity of other funding sources may represent good buying opportunities for funds with significant dry powder. When it becomes clear that private equity is one of the few remaining sources of funding, PE firms will also be in a strong position to seek controlling stakes in investment targets. This would continue a trend that has developed in recent years: while in 2005, only 3% of MENA transactions were control buyouts, by 2008 26% of transactions’ volume and 50% of transactions’ values were control buyouts.

Low valuations will not, by themselves, be a sufficient driver to make investments. Due diligence is playing a bigger role in all investment decisions and there is a more cautious and strategic approach to assessing value. This suits the private equity landscape of the MENA region where substantial debt packages have been less available to buyout firms and the PE model has concentrated less on using low cost debt to increase IRR.

Evolving Trends
In the years preceding the credit crisis, private equity in the MENA region evolved rapidly. Prior to 2004, private equity barely featured on the MENA financial landscape but the industry has since grown rapidly. Driven by the increase in oil revenues and the stellar growth of MENA economies, the number of funds focused on the region has grown to over 100, raising $19.6 billion in capital in four years.

The region has not been immune to the global economic downturn, however, and the latter half of 2008 saw a change in the MENA private equity landscape. In the intervening months, trends in how the MENA private equity industry will evolve in the medium term have become more apparent.
THE SHORT-TERM APPROACH IS OVER

In contrast to recent years, IPOs do not represent a viable exit strategy to the vast majority of investors in 2009. Limited debt availability means that trade sales are also unlikely and the decrease in valuations makes a secondary sale unattractive. Investments are therefore being held for longer and GPs’ key priority now is focussing on creating value and managing risk in portfolio companies.

Since streamlining and the increase in markets can no longer be relied upon to maximise exit potential, management are having to focus on balanced cost reduction programmes, refinancing of existing debt, improving cash collection and increasing performance and efficiency from existing assets and operations. In the new PE landscape, LPs are also taking a more active role in the running of portfolios and are insisting on an increase in strategic thinking and information provision from GPs. Financials are being delivered on shorter timeframes so that LPs can assess clearly, and on an ongoing basis, the health of their investments.

FOREIGN INVESTORS CONTINUE TO SEE THE MENA REGION AS A GROWTH MARKET

The combination of high levels of natural resources, industries with huge growth capability and governments that increasingly encourage private investment means that the MENA region continues to be attractive to foreign investors. Players who are unfamiliar with the market will need to tap into local knowledge if they are to make successful investments. Large companies in the region are often family-controlled or owned by governments or sovereign wealth funds and aligning the interests of an investor and the family or wealth fund will be important. In addition, local insight and will be essential to structure deals and ensure that they are legally watertight.

In early June 2009, Gulf Capital, a buyout firm based in Abu Dhabi, announced that it had secured AED 1.75 billion ($476.6 million) in commitments for a new fund, largely from international investors. This was the first private equity fund in the region to raise most of its capital from international investors, with two thirds of the investors being from outside the GCC.

HEALTHCARE, INFRASTRUCTURE AND UTILITIES WILL BE THE MOST ACTIVE SECTORS

Most of the MENA private equity community agree that defensive sectors such as Healthcare, Infrastructure and Utilities will prevail as a main focus for investors. Education and Consumer Goods retail may also be added to the list, as the expected GDP and population growth in several MENA countries are expected to sustain investment in these sectors.

Healthcare, Infrastructure and Utilities attracted an aggregate of 46% of total investments in 2008. Of this, Healthcare represented 16%, and will continue to be the primary focus of GPs in the medium term, according to many estimates. MENA population growth, increased longevity and a move to unhealthier diets and lifestyles will be drivers in the Healthcare market and there are increasing opportunities for investors as governments seek to increase current low private sector penetration in healthcare provision. In what was taken as a clear sign that Saudi Arabia’s government is looking to divest some of its health expenditure financing burden, in October 2008, Manar Al-Moneef of the Saudi Arabian General Investment Authority described the current Saudi healthcare funding model as ‘unsustainable’. And in a recent report, some of the foremost players in the GCC private equity industry set out a compelling case for private sector involvement in facing the region’s future healthcare challenges.

Infrastructure needs in the MENA region remain high and will only grow with increasing populations, and many MENA governments are keen for private participation in infrastructure projects. Utilities and Power are also government priorities and may present opportunities for investors. In particular, the threat of water scarcity and the need to increase water capacity has ensured that investment in water projects is a priority in the region.
EGYPT, SAUDI ARABIA AND THE UAE WILL BE THE KEY GROWTH GEOGRAPHIES

In terms of geography, the bulk of PE investments between 2005 and 2008 focussed on Egypt, Saudi Arabia and the UAE. In 2008, investments in Egypt, Saudi Arabia and the UAE accounted for 19%, 17% and 14% respectively of all investments for the year.

The focus is expected to remain on these jurisdictions. Saudi Arabia represents around 40% of the GDP of the region and still has huge liquidity and large infrastructure projects being developed. At a recent G20 meeting, King Abdullah stated that he expected Saudi infrastructure expenditure to exceed $400 billion over the next five years. In addition, the Kingdom has, in recent years, adopted economic liberalisation policies in order to encourage foreign investment.

Egypt too has made rapid progress on regulatory reforms, opening up sectors to foreign direct investment and allowing private equity players to enter the market. Its sheer population size is also seen as a driver for future investment opportunities. In the UAE, economy diversification initiatives and the development of tourism and free zones has made Dubai and Abu Dhabi, in particular, hubs for investment. Government plans on extensive privatisation over the next decade, a focus on public-private participation for infrastructure projects and the influence of the financial talent that has moved to the UAE in recent years is likely to mean that it remains a focus area for private equity firms.

Some experts suggest that Bahrain and Kuwait are also ripe for investment opportunities, since prices in the two countries are approximately half of what they were a year ago. Many investors will also focus on regional funds rather than on country specific funds to diversify risk.

IMPROVEMENTS IN CORPORATE GOVERNANCE AND REGULATION WILL CONTINUE

Inconsistent regulation and a lack of transparency in MENA companies have traditionally been seen as barriers to investment. However, there is a willingness to reform. The GCC countries are leading the way but other countries such as Egypt and Jordan are adopting business-friendly regulations, albeit slowly.

MENA businesses are also increasingly becoming accustomed to transparency and due diligence requests. There is still a need to improve corporate governance practices but many MENA firms will realise that, in a depressed market in particular, investors are willing to pay a premium for companies with good corporate governance practices.

Hawkamah, the Institute for Corporate Governance based in Dubai, has launched a Private Equity Task Force to develop corporate governance guidelines for private equity firms and portfolio companies in the MENA region and Dr Nasser Saidi, founder and director of Hawkamah, believes that MENA private equity has a critical role to play in diffusing good corporate governance practices in local portfolio companies.

ISLAMIC FINANCE

Before 2006, Islamic finance was a largely unfamiliar term outside of the Middle East and Asia. Its move into the mainstream was rapid and, although the Islamic finance market remains a small fraction of global assets, its potential has been recognised, with many of the world’s largest western-based finance groups launching Sharia-compliant facilities and products. The number of Sharia-compliant equity funds increased from 400 in 2006 to 500 in 2007.

In the wake of the global credit crisis, Islamic finance is also being examined for the lessons it can teach western-style banking. Islamic finance is traditionally conservative, focussing on transactions where an asset can be understood and properly assessed by financiers.

While predictions that the Middle East will be primarily based on Islamic finance within five years may be optimistic, the majority of PE players in the MENA region expect to see an increase in Sharia-compliant funds due to the general growth of interest in Islamic finance.

For questions or comments on this article, please contact:
Charles Fuller (+971.4.704.6328), Tim Ross (+971.4.704.6344) or Frances Coats (+971.2.495.1773).
## HISTORICAL DATA

### 2009 YTD

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<th>Target dominant sector</th>
<th>Target dominant country</th>
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<th>Seller company</th>
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OVERALL ACTIVITY IN THE MIDDLE EAST

BREAKDOWN OF MIDDLE EASTERN M&A ACTIVITY BY DEAL TYPE: VOLUME

OUTBOUND CROSS-BORDER M&A ACTIVITY FROM THE MIDDLE EAST

BREAKDOWN OF MIDDLE EASTERN M&A ACTIVITY BY DEAL TYPE: VALUE

Dubai Roundtable: post-event report
www.mergermarket.com/events/
SECTOR SPLIT OF M&A IN THE MIDDLE EAST 2009 YTD: VOLUME

DEAL SIZE SPLIT OF M&A ACTIVITY IN THE MIDDLE EAST 2009 YTD: VOLUME
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*Source: Thomson Financial*
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“THERE SEEMS TO BE A SIGNIFICANT AMOUNT OF FUNDRAISING AND FUND CREATION GOING ON. I’M RATHER SURPRISED THAT PEOPLE ARE SO BULLISH.”

Tim Ross
NOTES & CONTACTS

The following notes pertain to data contained in this publication:

• Deals are included where the deal value is greater than or equal to €5m.

• Where no deal value has been disclosed, deals are included if the turnover of the target is greater than or equal to €10m.

• Transactions excluded include property transactions and restructurings where the ultimate shareholders’ interests are not changed.

• Deals are included in the graphs for each section if the target is a European company.

• The list of Top Deals and the data underlying the League Tables are based on deals where the bidder, target or parent of either is a European company.

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