MENA PRIVATE EQUITY ASSOCIATION

MENA Private Equity Association

Private Equity Best Practices for Post-Acquisition Planning and Execution in MENA

LONG-TERM VALUE CREATION IN PRIVATE EQUITY INVESTMENTS

In collaboration with:

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This Report was developed in collaboration with the MENA Private Equity Association, regional private equity professionals, and Booz & Company.

MENA Private Equity Association

The MENA Private Equity Association is a non-profit entity committed to supporting and developing the private equity and venture capital industry in the Middle East and North Africa. For further information, visit www.menapea.com.

We would like to thank the participants for their time.

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1 Executive Summary

The MENA region poses challenges for private equity firms: unsophisticated legal and regulatory frameworks, restricted use of financial leverage, difficulty obtaining controlling stakes in companies, a strong owner/manager culture that can create tensions, limited incentive options for managers and a scarcity of talent. Add to these persistent challenges new obstacles since the financial crisis. Valuations of target companies are high, yet the IPO market is weak and liquidity is constrained.

Creating value at portfolio companies is tougher and exits take longer than before the financial crisis. The consensus among private equity leaders who met recently for a roundtable discussion in Dubai was that creating value depends upon careful post-acquisition planning and execution. In terms of post-acquisition planning, PE firms should develop granular value-creation plans upfront, scrutinize existing management teams to understand the talent in house, secure key personnel such as financial managers, focus on corporate governance to secure post-acquisition influence, and early planning for exit.

After the acquisition, it's critical that PE firms keep the value-creation plan on track with diligent execution. Firms need to develop collaborative and close relationships with management, groom owner/managers for new roles that complement the new direction of the company, align incentives with management teams, judiciously select board members who will push forward the value-creation plans, and implement efficient information flows and monitoring so the PE firms understand if milestones and goals are being met.

But just knowing what to do is not enough. Execution also depends upon the PE firm having strong internal capabilities in the form of talent and expertise. Sometimes this requires looking within the PE firm itself and its network of portfolio companies, and other times firms must cobble together a network of outside experts either on retainer or on call. Ultimately, firms with the right capabilities in place can look to the MENA region for significant opportunity.

2 Challenges and Best Practices

The MENA region poses unique challenges to deal execution. Below is a summary of those challenges and the best practices PE practitioners discussed to overcome them.

Challenges

- Unsophisticated legal and regulatory framework
- Restricted use of financial leverage
- Difficulty obtaining controlling stakes
- Strong owner/manager culture
- Limited incentive options for managers
- Scarcity of talent

Planning Post-Acquisition Value Creation

- Develop granular value-creation and exit plans upfront
- Scrutinize existing management teams
- Secure key personnel
- Focus on corporate governance to secure post-acquisition influence

Execution After Acquisition

- Develop collaborative and close relationships with management
- Groom owner/managers
- Align incentives with management teams
- Select board members judiciously
- Implement efficient information flows and monitoring

Deploying Firm Resources to Oversee Investments

- Single partner approach
- Active partner approach

Building Capabilities

- Identify talent within the PE firm
- Recruit from portfolio companies
- Build a bespoke network

3 Returning to the Fundamentals

The investment philosophy of private equity firms in the MENA region has changed dramatically since the financial crisis, according to leaders of regional private equity firms who met recently for a roundtable discussion in Dubai. There is a more intense focus on post-acquisition planning and execution to create value.

Before the crisis, private equity firms could often exit an investment in 18 months or less thanks to a robust local IPO market. Today, the same profits take more time and effort. There are several reasons behind this shift: Acquisition targets remain expensive and opaque, and so PE firms must dig deep to get a true understanding of the company's financial condition. Also, liquidity is constrained, which means that operational improvements are critical to conserving cash and shoring up balance sheets. And because the IPO market is weak, the holding period is longer and PE firms are more deeply involved with portfolio companies.

In this environment, roundtable participants said, private equity firms must return to the fundamentals of their own industry, which means getting involved with operations and actively creating value over an extended period of time. This, in turn, requires careful post-acquisition planning and strategy execution. "It's critically important," said one attendee "The way we're going to make money in this market is by really creating value at the business level."

But creating value at the business level isn't easy, participants agreed. The MENA environment poses special challenges to private equity firms--challenges that PE firms in developed markets don't face--which can hinder post-acquisition planning and execution. In a wide-ranging discussion, participants shared best practices and made recommendations for overcoming these challenges. They also acknowledged that knowing what to do and having the internal capability to do it are two separate issues. The discussion, therefore, eventually turned to how PE firms can build and deploy the internal capabilities necessary to follow these recommendations for post-acquisition planning and execution.
The unique challenges private equity firms face when doing business in the MENA region include:

Unsophisticated legal and regulatory frameworks

In developed markets, legal and regulatory procedures are well established and enforcement responsibilities clearly assigned. This is not the case in MENA, where the capital markets infrastructure is still fairly young. Contracts and IPO procedures are not always enforced, and sometimes there is confusion over who should enforce them. Many MENA countries also restrict foreign ownership and types of share classes. "In these lax legal frameworks that we have in the region, any shareholder agreement is really non-enforceable," said one participant.

Restricted use of financial leverage

In the Western markets, private equity firms are free to use leverage, derivatives and other complex financial instruments to accelerate value creation. In the MENA region PE firms can't employ financial leverage the same way for several reasons: liquidity pools are drying up and so borrowing from banks is difficult; even when borrowing is possible there are no tax shields and benefits; there is also an absence of complex financial instruments in key markets such as Saudi Arabia since these instruments are not Shari'ah compliant, the lack of an adequate legal and regulatory infrastructure to enforce these complex financial instruments in other jurisdictions, and sub-optimal legal frameworks (bankruptcy laws make the use of leverage more risky).

Difficulty obtaining controlling stakes

In developed markets, private equity firms often buy a controlling stake. This gives them the power to restructure management and pursue operational improvements as they see fit. But it's rare for PE firms in the MENA region to obtain this level of control. Most deals involve family-owned businesses and these owners won't relinquish control, forcing private equity to take significant minority stakes. As a minority investor, PE firms have more limited options for how they can fix the business. Government regulations around foreign ownership can also stymie efforts to obtain a controlling stake.

Strong owner/manager culture

As a minority investor, tensions with an owner/manager unused to outside interference can hinder value creation. Early on, management and investors must agree on key priorities and share a real, sincere willingness to implement the changes necessary post investment; otherwise, as one PE partner put it, "you'll get into a lot of these problems or challenges down the road."

Limited incentive options for managers

In Western markets private equity firms can align priorities with management using stock options and other forms of performance-linked compensation. But given managers' limited experience with equity-linked compensation in the MENA region, the uncertain and complex tax implications in some jurisdictions, as well as the absence of large, liquid public markets to fairly value such instruments, these compensation structures aren't popular. Managers continue to prefer short-term cash bonuses, which makes aligning managers' incentives with long-term goals difficult.

Scarcity of talent

Even if a PE firm can make hiring and firing decisions, its options are limited by a shallow pool of experienced senior executives in the MENA region. Managers can't be easily replaced. Finding experienced CFOs, for instance, is difficult and many companies must do without. In developed markets, by comparison, there is "a very broad pool of managers, thousands of people they can choose from," said one participant. "Managers that can be incentivized in a way where they would make a superhuman effort to create value, and if they don't work, they get fired within six months."

These six challenges make value creation in the MENA region difficult, but the problems are by no means intractable. What's necessary, PE partners at the roundtable agreed, is a renewed commitment and focus on planning and executing post-acquisition, value-creation strategies. Quick turnarounds are a thing of the past, but there are still exciting opportunities in the region.

4 Planning Post-Acquisition Value Creation

The first step to creating long-term value is to have a post-acquisition plan in place, consisting of five key elements.

1. Scrutinize existing management teams

Due diligence usually focuses on business operations, financials, and market positioning. Too often, however, the due diligence on the management team is inadequate. That is a potentially serious oversight given that PE firms may need to work with existing managers for years to drive value creation. “You need to ask if the management team is the right one to implement these changes. Do they have these skill sets? Do they have the mentality to do that?” said one participant.

Before committing to a deal, a PE firm often needs confidence that the right people are already in place who can execute a value-creation plan. They need to scrutinize these managers’ backgrounds and competencies. Another PE player said: “Unless it is a turn-around situation, we will not go into a deal where change in management is required. Management for us is the most critical part of an investment.”

Just as important is a “gut” check, especially if the project might last five or six years. “The time factor is important, and how long you plan to stay as a partner. If you’re looking at one to two years you can foresee how things will work and do your background checks. But the problem arises when you’re staying much longer.” Beyond a few years forecasting is difficult, the speaker said, so partners need an intuitive sense they can work together through thick and thin. “If you don’t trust the management, and you don’t believe that this is going to be a credible, flexible, open minded partner for the time period, then don’t go there.”

2. Secure key personnel

Some family-owned businesses lack key executive positions that should be filled before a PE firm makes an investment. In particular, many companies employ a lower level financial manager instead of an executive level CFO. “When dealing with owner-managers, one of the biggest gaps is CFOs. This is a scarce resource. In many cases, accountants are filling the CFO role,” one participant mentioned.

If the company is large enough, recruiting a CFO may be important to help design and implement a financial strategy, review banking relationships, support value creation and facilitate the exit. In the case of a smaller company, a PE firm might only need to augment financial capabilities with its own expertise. Either way, strategic financial capabilities are essential to creating value.

“If you go public, a good CFO could be your most important asset,” said one participant. “A CFO is someone with a public face. If you want someone technically strong, get a solid accountant. But you could have a guy who’s good with numbers but useless as a public CFO.”

3. Focus on corporate governance to secure post-acquisition influence

As a minority investor, PE firms need a corporate governance framework that secures their influence. How many board seats will they get? What will their voting and veto rights be? What’s their access to information?

Too often, instead of governance, PE firms focus on complex deal-structuring terms, which can be off-putting to the majority shareholder. Given the local culture, participants at the roundtable agreed that it’s better to simplify these term sheets and try to win concessions on the corporate governance structure--such as an extra board seat--to help the PE firm drive and execute the value-creation plan.

One of the most critical issues is the board. One participant said “we rarely accept anything but a position where we are basically controlling the board – a majority stake. A shareholder agreement is not really enforceable. If you don’t have the relevant control, it will take years to …create the value.”

Another recalled the hazards of not having board control. “We were the largest shareholder in a publicly listed company. We had board seats, but limited, which in reality equaled no shareholder rights. Despite numerous presentations and discussions with individuals, where we would get a nod of approval and agreement, nothing would happen. On the other hand, we’ve had positive experiences where board controls were in place.”

But board seats are not the only governance issue to consider. “There are some things that we believe need to be done literally in the first hundred days,” said one speaker “Information flow [and] certain levels of control over the business have to be in place. And those have to be agreed upon. We’re not going to sign on this deal unless these critical control aspects are in place and everybody can see where we’re going.”

4. Develop detailed value-creation and exit plans

Firms must spend adequate time developing granular, operationally detailed value-creation plans and securing buy-in from management before investing. Typically, PE firms outline very high-level value-creation plans and leave it at that. But roundtable participants said that to drive serious operational improvements PE firms need to delve deeper.

Before investing, PE firms need a 100-day plan, an annual business plan, and a three-to-five year strategy—and the owner/managers need to buy into these scenarios. Also, given the constrained IPO market, PE firms need to create detailed, realistic scenario-driven exit strategies. Management should agree to these exit strategies before the investment is made. Without an exit plan, and without management buy in, the PE firm risks being stuck with an illiquid investment and becoming, in effect, an investment holding company.
Part of this planning process should include setting performance metrics and milestones to track valuation creation. That said, surprises and setbacks are almost inevitable and PE firms must be flexible. One participant said: “You thought you were going to do something in six months, but you discover licensing itself takes six months, so you’re not going to get it done.”

5 Executing After the Acquisition

Planning is almost irrelevant if execution falls short. Roundtable participants described five crucial steps to keeping the agenda on track after the acquisition.

1. Develop collaborative and close relationships with management

Given the years of hard work involved, PE firms need to build strong collaborative relationships with the management team. This involves an ongoing, transparent exchange of information. "In terms of engaging with management, that's a constant communication and an almost daily interaction," said one PE partner.

Of course, the dynamics of the relationship will vary from deal to deal; collaboration is easier when the investment is for growth than when it's for a turnaround. But participants cited a number of ways to build both trust and management's capabilities—some as simple as organizing meals where people can gather and talk. "You bring in other soft ways of gaining their trust," said another PE player. "For example, you can hold portfolio company conferences, forums for the CFOs, the IT teams."

He added that in the interest of maintaining harmonious working relationships, PE managers should use restraint when exercising their rights. Insisting on a certain CFO over the objections of the CEO, for instance, is bound to cause problems down the road. "If you apply your common sense and don't become too overbearing for the portfolio companies, for the managers, they'll trust you, they'll work with you."

2. Groom owner/managers

Building a collaborative relationship with the owner/manager takes finesse. This person is often highly sensitive to being perceived as losing power and may resist stepping aside even when it's necessary to drive change. "He wants to show that the presence of the PE firm is a strengthening, not a weakening, of his position," said one PE manager.

One tactic to preserve an owner/manager's status and make way for change is to groom him to assume a more supervisory, higher-profile role, perhaps becoming a director or chairman. This arrangement can work for both sides. The owner/manager enjoys the prestige and the media attention that goes with being the public face of the institution, while the PE firm benefits by freeing up a key position for a more experienced manager. "They get to take their summer vacation without anyone annoying them – they like that. We had two such experiences, and they worked very well."

3. Align incentives with management teams

Aligning incentives with managers is tricky; tactics that work in more developed markets often fail in the region. Managers in the region are accustomed to receiving annual cash bonuses and generally don't care for stock options; as noted earlier, it's difficult to value these options when the company is private and local markets are relatively immature and illiquid. "From our experience, equity is not properly valued. Even if you introduce it and they understand it, it's not really in most cases the incentive," said one PE partner.

But given the need to align long-term incentives, PE firms need to find creative ways to structure these cash bonuses and lengthen the payout. One PE manager said his firm abandoned the idea of offering equity and instead created a $5 million pool available at the exit. "They understand that much more than saying you have 5 percent equity."
Another manager said: "Typically we do [a long-term incentive plan of] about 5 to 10 percent, which is given to the senior management. In some cases we have gone down to middle management as well."

4. Select board members judiciously

Independent directors are fairly new to the region's boards of directors, but roundtable participants said their numbers are growing. From a PE firm's perspective, independent directors add value in several ways: They bring expertise and a fresh perspective to drive operational results, they provide balance between the views of the majority owner and the PE firm, they can sway the majority owner to give up more board control (instead of handing more seats to the PE firm), and they can free up the PE firm's staff to focus on management issues. "Recently we've started insisting on independent directors… that's one of the ways to balance the board of directors," said one PE player.

But to be effective, these directors must be empowered to act independently from both the management and the PE firm. These directors need the right skill set and they should put some notional amount of money into the business to give them a monetary stake in the outcome. This arrangement ensures they have the best interest of the company at heart, and gives them the incentive to speak up and help drive value creation. If an "independent" director doesn't have the correct talent and is just collecting a paycheck from the PE firm, the seat risks becoming an almost ceremonial position.

With all this in mind, speakers said PE firms need to develop a network of potential independent directors. Indeed, these networks may become a source of competitive advantage by allowing PE firms to drive value creation faster. Some PE firms ask these directors to invest in the company in order to guarantee the directors remain committed and engaged. But this investment must be small--less than half a percent--or they risk being seen as too closely aligned with the PE firm.

While acknowledging the value of independent directors, one PE speaker said he still prefers to have his own people on the board, particularly early on to make sure the turnaround gets off on the right foot. Educating the owner/manager on the value of independent directors can also take time. "Those we have dealt with so far haven't been aware of the importance and helpfulness of having an external or independent director. Overtime, if you're able to win trust, that changes, but to date we've been almost exclusively represented by our team members."

5. Implement efficient information flows and monitoring

Open channels of information are critical to monitoring progress but these channels can be difficult to establish, particularly with a family-owned business unused to corporate disclosure and transparency. Ideally, the PE firm will build relationships with senior, middle and lower management to tap multiple levels of the organization for information. But the firm must be mindful never to go behind the CEOs back--or even be perceived as doing so. "It's helpful to be able to talk to lower levels, but the relationship has to be built at the highest level first. The higher level can open or close access."

PE firms also need to avoid overburdening managers with information requests--an all too common complaint. They and boards should agree upfront on the frequency of reporting as well as the type of data, which will vary depending on the nature of the PE investment (e.g., growth financing vs. turnaround financing).

6 Deploying Firm Resources

During the roundtable discussion participants made a distinction between knowing how to improve post-acquisition planning and execution and having the internal capabilities to actually do so. Therefore, after offering their recommendations for planning and executing strategies, they turned their attention to how PE firms can deploy or build the necessary capabilities to follow these recommendations. It is imperative, the group agreed, that PE firms cultivate a group of employees or network of experts with operational expertise. When called upon, these experts can help management formulate growth plans, expand margins and release trapped cash, often in the intense 100-day period after the deal closes.

Roundtable participants cited two models for deploying a PE firm's resources based on the type of investment.

Single Partner Approach

In this approach a partner heads a core team to lead the portfolio company at every stage of the deal, from investment to deal execution to value creation to exit. Some PE firms complement the core team with experts and outside consultants to help manage the operations. Participants said this approach is most effective when the portfolio company has a great track record, a very good management team and is looking for growth capital. Since these companies aren't in turnaround mode, there are fewer demands on the PE firm's own operational experts. "We tried different models but we eventually gravitated towards the single partner approach. There is one guy that is responsible for that investment throughout its life," said one PE partner.

Active Partner Approach

Here two teams are involved: an investment team and operations team. This approach is most appropriate when the company needs to improve performance or is a turnaround play. After the investment, an operational team with specialized knowledge of the industry and financial situation fills various key positions--such as CFO or business development--until the company is stabilized and new managers are recruited. Even though two teams are involved, the same partner is ultimately held responsible for the company's performance. The investment team remains in charge until the exit.

Participants warned against using what they referred to as the "handover approach"--when an investment team, which conducts pre-acquisition activities, hands over responsibility to an operations team, which pursues post-acquisition execution. The problem with this arrangement is it muddies accountability for the overall performance of the investment.

7 Building Capabilities

When it comes to locating expertise or building internal capabilities at the PE firm--particularly the operational talent to help build value in portfolio businesses--roundtable participants cited three options based on a PE firm's size and existing portfolio of companies:

Identify talent within the PE firm. Deploy managers across portfolio companies as needed. This approach requires a large PE firm with the resources to employ a roster of high level managers ready for deployment.

Recruit from the network of portfolio companies. This approach only works for large PE firms with significant scale and reach across industries both locally and internationally. Managers within this network of portfolio companies form SWAT teams that rove from one new portfolio company to the next. The PE firms makes a new investment, the SWAT team arrives, assumes key management positions, creates short-term value, stabilizes the company, hires their own replacements, and then leaves.

Create a bespoke network. This approach is ideal for smaller PE firms with neither the resources for a large in-house staff of operational experts, nor a network of portfolio companies. Instead, these PE firms build a network of operational partners or "entrepreneurs in residence" who are on call to assume management or board positions or serve as advisors on a case-by-case basis. They are not on the PE firm's payroll; instead, the portfolio company pays them with a salary, bonus or equity.

The arrangement benefits the operational experts--who get high-level experience, connections and sometimes an opportunity to buy into the company (typically 1 or 2 percent)--as well as the PE firms--that can access this operational experience without significant expense. "We have what I call a 'C' database--for C-level executives--whom I can approach if I need," said one PE partner.

Another way a PE firm can build a bespoke network is to put experts on retainer, have them sign a non-compete agreement, and pay them directly. This is more expensive than just having them on call, but it's less expensive than hiring them full time and it guarantees their availability. "With some advisors, we bring them into an exclusive contract in that country or sector. We usually hire advisors who are experts in certain industries."

8 Conclusion

The PE partners who participated in the roundtable concurred that a distinct shift has occurred in the industry: from a focus on quick turnarounds and short-term profits before the financial crisis to long-term value creation today. In this environment, PE firms need to intensely plan and execute post-acquisition value creation strategies--and that requires tackling a host of challenges unique to the MENA business environment. All in all the tone of the roundtable was optimistic. The challenges in MENA, though significant, are far outweighed by the enormous opportunities for those PE firms that can develop the right capabilities and deploy them wisely.