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Client Alert

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Private Equity Landscape: The Kingdom of Saudi Arabia

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According to the research of a major Middle East private equity firm, Saudi Arabia accounted for 23 percent of private equity transactions in the Arab world over the past decade, trailing only Egypt and the United Arab Emirates.[1] To date, the private equity landscape in Saudi Arabia has predominantly been dominated by local and regional players, including private equity firms, sovereign wealth funds and family offices, who are able to capitalize on their knowledge of the market, local relationships and lower barriers to entry. However, international private equity firms have shown great interest in the Saudi Arabian market.

According to 2009 estimates, Saudi Arabia is the 23rd largest economy in the world, and the largest economy in the Middle East, with a GDP (purchasing power parity) of US $585.8 billion.[2] By all quantifiable measures, the Saudi Arabian economy is expected to continue to grow given its position as the world's largest oil producer, and the continued diversification of its economy. In addition, the Saudi Arabian government has made a large-scale commitment to investing in new projects across a wide spectrum of industries, including petrochemicals, oil and gas, power, healthcare and infrastructure, and has undertaken wide ranging economic and regulatory reforms to make the country more attractive for investment.

Even though private equity activity has been relatively limited as compared to more developed markets, the potential in the Saudi market is immense as the country continues to grow and the government continues its economic and regulatory reforms. As such, Saudi Arabia presents a great number of potential opportunities for local, regional and international private equity players.

In this *Alert*, we identify some of the major issues to be considered by any private equity firm looking to make an investment in Saudi Arabia, as well as highlighting a number of ongoing reforms which may make Saudi Arabia an even more attractive jurisdiction for private equity activity in the coming years.

Issues for Private Equity Firms to Consider in Investing in Saudi Arabia

- **Licensing of Foreign Investment.** Any company with foreign shareholding that intends to make an investment in Saudi Arabia must obtain a foreign capital investment license from the Saudi Arabian General Investment Authority

(SAGIA). The default position is that a foreign entity may invest in all activities in Saudi Arabia, however there are certain types of activities which are specifically prohibited from being carried out by foreign investors. These activities are set forth in a "Negative List" which is issued and periodically updated by the Supreme Economic Council, and SAGIA will not issue a foreign capital investment license to any foreign company intending to engage in any such activities.[3] Any private equity firm that is investing through a vehicle outside of Saudi Arabia will therefore be required to obtain a foreign capital investment license from SAGIA and has to make sure that it is not investing in any of the activities published on the "Negative List."

- **Structuring of Investments.** The Saudi Arabian companies regulations are generally less developed compared to the rules regulating the establishment and conduct of corporate vehicles in other jurisdictions in which private equity firms may be more accustomed to operate. The two most typical forms of legal entities in Saudi Arabia are (i) the limited liability company (LLC) and (ii) the joint stock company (JSC). Therefore, any direct private equity investment will most likely utilize one of these two corporate forms. Each form has certain limitations. For example, an LLC requires a minimum of two shareholders and a JSC requires a minimum of five shareholders. In addition, while a Saudi LLC typically limits shareholder liability to the value of such shareholder's shares, shareholders may be held jointly liable for all company debts if losses exceed 50 percent of the capital and the shareholders fail to dissolve or recapitalize the company within a certain period of time. In addition, under both an LLC and a JSC, dividends may only be distributed out of net profits, and if any unearned profits are distributed, such dividends may be clawed-back by the company's creditors. Furthermore, under both an LLC and a JSC, at least 10 percent of a company's net profits must be set aside each year to build up a statutory reserve fund. The shareholders may, by resolution, discontinue setting aside for such statutory reserve once the aggregate amount of the reserve equal at least 50 percent of the company's capital.
- **Exit Strategy.** Given the relatively short investment horizons of most private equity funds, clear and predictable exit strategies are crucial. Under a JSC, founding shareholders are subject to a third-party lock-up period of at least two years, therefore potentially limiting an investors' ability to realize their investment during such period. In addition, shareholders under an LLC have pre-emptive rights that cannot be waived or transferred, thereby potentially limiting the ability of an investor to sell its interests in an LLC without first gaining the approval of other shareholders. In addition, there are limitations to utilizing an initial public offering (IPO) exit strategy since, with limited exceptions, only Saudi Arabian and GCC investors are permitted to purchase shares in Saudi Arabian publicly listed companies. While the Saudi IPO market was quite active prior to the credit crisis, it has slowed down in the last 18 months. However, there appears to be renewed interest in the IPO market, which could make it a more viable option for private equity as an exit strategy going forward.
- **Financing Products.** Private equity players have historically depended on leverage in their investment strategies. While there is a strong and well capitalized banking community in Saudi Arabia, and while there have been acquisition financings in the past, there are a limited range of acquisition financing products currently available. This is partly due to the fact that it is often difficult to perfect security, and therefore banks typically lend against corporate credit, and may not be as willing to provide credit to a private equity firm to finance a leveraged buyout without a parent guaranty from the firm or

other additional security beyond what private equity firms may be accustomed to in other jurisdictions.

- **Tax Considerations.** Foreign private equity firms are generally subject to a 20 percent tax on all capital gains. In addition, management fees are also typically taxed at a 20 percent rate. Therefore it is crucial for any private equity firm considering an investment in Saudi Arabia to first seek appropriate tax advice.
- **Other Regulatory Considerations.** Depending on the industry in which a private equity firm is seeking to invest, there may be other regulatory issues to consider. In fact, depending on industry, a foreign investor may be required to seek appropriate regulatory approval prior to obtaining a foreign capital investment license from SAGIA. For example, investments in telecommunication sector may require approvals from the Communications and Information Technology Commission and investments in the healthcare and pharmaceutical sector may require approvals from the Ministry of Health and/or the Saudi Food and Drug Administration. In addition, an investor should be aware of the Saudi competition law whereby the Council of Competition Protection at the Ministry of Commerce has to approve any acquisition which will create a "dominant position" in the market, *i.e.,* a position where an entity is able to influence prices in a certain market.
- **Other Potential Considerations**. Broad reluctance of family-owned companies to relinquish control, high valuation expectations, a unique social framework, a guarded business culture and talent scarcity are some of the factors that have made it difficult for external investors to complete deals in Saudi Arabia. Thus, a physical presence with the appropriate level of knowledge of the business environment in Saudi Arabia, along with a deep understanding of the social setting become a key to success for private equity investors.

Ongoing Reform in Saudi Arabia

According to a World Bank report,[4] Saudi Arabia is the seventh fastest reformer globally, and second fastest within the Middle East and North Africa (MENA) region. Recently, a new judiciary law was enacted in Saudi Arabia to establish specialized courts in order to streamline judicial process, which is viewed as being a positive step for encouraging investment activity in Saudi Arabia. In addition, a new set of regulations for companies is in the process of being developed and is expected to be enacted in the very near future, which could alleviate some concerns regarding inflexibility of corporate forms. Furthermore, a new mortgage law is being developed which could help creditor concerns regarding ability to perfect security in Saudi Arabia and provide for new financing products that can be utilized by private equity firms. The Saudi Arabian government is heavily investing in large-scale projects such the Economic Cities project, which in their implementation will require large private sector investment, including private equity investment.

Conclusion

In the short-term, firms are likely to continue monitoring the private equity landscape in Saudi Arabia as the country continues its pursuit of a market-oriented, private-sector-driven economy with a business and investment culture favorable to greater foreign participation, and are likely to continue making strategic investments to capitalize on such favorable opportunities. With the tremendous growth potential of Saudi Arabia, coupled with an increasingly progressive regulatory environment, the long-term view is that, it is likely that there will be an increase in private equity money attracted to Saudi Arabia. In either case, the potential opportunities for local, regional and international private equity firms are significant, bearing in mind the unique characteristics of the Saudi Arabian market.

Endnotes

1 Financial Times article 'Private equity sizes up Saudi Potential'; 14 June 2010.

2 Central Intelligence Agency, the World Fact Book, Country Comparison: GDP (Purchasing Power Parity), https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html.

3 Most current negative list is available on SAGIA's Website (http://www.sagia.gov.sa).

4 World Bank and International Finance Corporation, *Doing Business 2010: Reforming Through Difficult Times*, Washington, D.C., Palgrave MacMillan, 2009, at p. 16.

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