



Growth Dynamics and Contours of the Next Phase of Evolution





Asset Management Industry in the GCC: Growth Dynamics and Contours of Next Phase of Evolution is a study (the "Study") conducted by Markab Advisory ("Markab") and sponsored by Qatar Financial Centre Authority ("QFCA"). The contents and opinions expressed in this document do not necessarily reflect the views of the QFCA. The sponsorship of this document by QFCA is with the objective of enhancing the awareness of and promoting discussion on the asset management industry in the GCC region, specifically for the development and growth of the financial services industry. Markab Advisory bears full responsibility for the contents of this document.

In preparation of this Study, Markab Advisory drew upon a multitude of information sources including published information, Markab's proprietary database and access to professionals in regional and international banks, multilateral organizations, family offices, law firms and asset management industry including mutual funds, private equity funds and hedge funds.

Markab conducted a series of in-depth interviews with CEOs, partners and senior executives of a number of leading organizations connected with this industry, including private equity groups, investment & corporate finance advisory firms, family groups' investment offices, law firms and investment banks. Many of the interviewees prefer to have their names kept confidential. Markab would like to extend its gratitude to all the interviewees for their time and valuable insights.

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I

Introduction

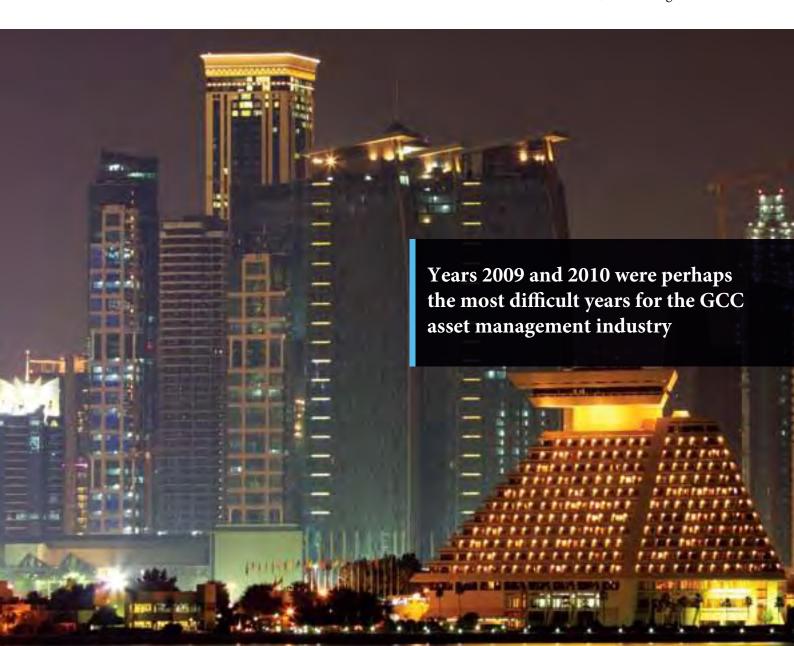
"A great stock, though with small profits, generally increases faster than a small stock with great profits. Money, says the proverb, makes money. When you have a little, it is often easier to get more. The great difficulty is to get that little." – Adam Smith, The Wealth of Nations.

The years 2009 and 2010 were perhaps the most spectacularly difficult years for the Gulf Cooperation Council ("GCC") asset management industry. The reverberations of the global financial crisis of 2008 were being severely felt in the GCC region. As a result, almost every segment of the industry was finding itself severely impaired. Before the crisis, almost all investment assets were growing

at a rapid, and in some cases, even astronomical pace (though the growth was not necessarily concurrent). Oil prices were touching new highs. There was a widespread view within the region's banking, investment and asset management industries that the region's vast oil wealth, the overall health of the banking system and the massive investment in infrastructure by the public sector

ring-fenced the GCC from any possible financial catastrophe worldwide. After all, the GCC had hardly felt the impact of the dotcom crash of 2000 or the Asian financial crisis of 1997.

Such assessments proved to be grossly misplaced. Despite impressive economic growth of the countries in the GCC, the local markets suffered a severe asset price deflation and, even though with a



time lag, a serious liquidity and debt refinancing crisis. The days of massive borrowing for property development and large scale infrastructure projects came to an end. Property prices in the most active GCC regions plummeted by up to 50%. Stock markets collapsed and trading volumes dropped. The young asset management industry almost faced an existential threat. A number of asset managers, including private equity houses were forced to either close down or downscale their operations. There was a major shake-up in the asset management industry across all asset classes. Fundraising effectively came to a halt. There were high profile defaults and standstills all around. Investors practically ceased new investment activities and

instead started taking stock of the severity of damage to their investment portfolios.

Just as few had expected the spectacular downturn of 2009 and 2010, not many would have predicted signs of recovery by 2012. The signals may appear relatively weak and subdued, but they are unmistakably present. Despite the severity of the storm, the global

financial markets are finding a new equilibrium, so much so that global stock markets are nearing their

pre-crisis levels. The first quarter of 2012 was recorded as the best

quarter in a decade. Although the United States, which was the epicentre of the financial crisis, is still not out of the woods, there is optimism about its recovery, and the financial system is functioning properly. Problems in the Eurozone seem more addressable than what it appeared last year although there are still concerns about the integrity of the union and drag of weaker

Not many would have predicted signs of recovery by 2012; Q1 has been the best quarter in a decade for global stock markets

economies on the overall growth of the Eurozone.



This recovery though is not a return to the 'old days of doing' business. Recoveries seldom are. This time, however, the shifts are fundamental and long-term. The balance of economic growth and wealth creation has clearly shifted from the West to the East. India, China and some of the other leading Asian economies are registering strong economic growth. This shift is creating very prominent structural changes in the asset management industry. Most importantly, Asia is the new hub of wealth creation and its share in global financial assets (excluding Japan's) is expected to increase from 16% in 2010 to approximately 30% by 2020. China's sovereign wealth fund and other public sector related entities are actively seeking strategic investments across the globe and today represent one of the most active investors in large global assets.

The GCC region is showing its own signs of recovery. Dubai, which appeared most severely affected, is showing definite signs of recovery of its core sectors. Compared to Greece, Dubai World's restructuring is considered orderly. Other large-scale loans of government and family owned corporates are being actively refinanced at lower interest rates

and higher tenors throughout the region. Saudi Arabia and Qatar have entered the next phase of massive infrastructure developments, whose cascading effects are already being felt in these economies.

During the past decade, the GCC has been making great strides towards liberalization of its financial services sector. Coupled with the growth in number and size of businesses, the region's financial sector has undergone significant transformation. The Kingdom of Saudi Arabia established Capital Markets Authority in 2003 which has shaped the

Asia's share of global financial assets (excluding Japan's) is expected to double in the next 10 years

investment banking and the asset management industry. UAE and Qatar established financial zones and world class physical and regulatory infrastructure. These were excellent steps to build a strong backbone for the capital markets. Unfortunately the financial crisis hit before these

centres could build sufficient depth and become strong financial clusters.

The most remarkable story in asset management was evolving outside the space of public markets, making the evolution of GCC's asset management industry rather unique. Among the various asset classes, private equity appears to have the most interesting story and the highest degree of impact on the industry. The regional private equity industry, negligible in size ten years ago, with assets of less than US\$ 1 billion, has grown at least 15 times its size within this period.





What is remarkable about the growth of the private equity industry in the GCC is that it is considered a very sophisticated and relatively nascent industry even by global standards. PE funds have long holding periods and require exceptionally talented investment and legal teams. Yet the industry grew at an explosive pace and was home-grown.

Although the PE industry has undergone major shake-up during the recent financial crisis, it appears to be the leading component of the GCC asset management industry.

As it re-emerges from the rubble,

the private equity industry once again has the potential to play an important role in the region's economies. It may have a significant impact on capital allocation to key sectors such as infrastructure, small and medium enterprises and the growth-centric corporate sector in the region. It can be a key catalyst in shaping the capital markets going forward as it seeks to exit its portfolio companies through listing.

In the intermediate term, it may not be the stock markets, rather private equity that may become the arbiter of capital allocation.

The Way forward - Key

Challenges and Issues

The questions therefore on the way forward are natural. What is the future of the asset management industry in the region? Despite the surplus investable wealth, will there be a deep enough market for local investors to repatriate substantial wealth back into the region? Can the local investors really take advantage of the local knowledge, network of relationships and greater opportunities of wealth creation? How will the challenges of current lack of depth in capital markets, absence of integration of the regional capital markets and somewhat opaque investment and ownership law impact the asset

management industry going forward? In addition to the local investors, how can international pool of wealth be attracted to the region?

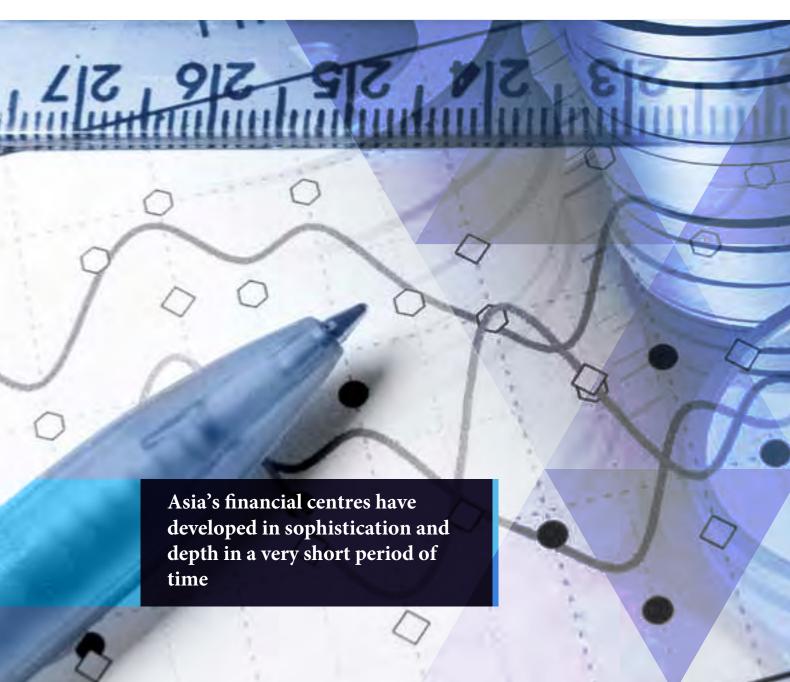
The asset management industry in the GCC region is presented with specific challenges. On a wide spectrum of its global peers, it is still a very young industry, which in its early years of evolution was confronted with the most damaging financial crisis in recent history. The recent Arab Spring will redefine capital flows from and into the economies impacted by the changes. The investment management industry in the GCC will be looking closely at these developments and

possibly seek ways to attract some of this capital from countries in the wider MENA region. Shifts in capital flows are not limited to the MENA region. The global economic rebalancing and GCC's growing trade relationships with Asia is another key shift in capital flows and will possibly be a key factor in shaping the GCC's asset management industry.

Another key challenge is the pace at which capital markets will develop in depth and diversity. Financial asset management is a regulated industry. Established global financial centres like London and New York did not achieve their success overnight; rather it took them several decades to reach where

they are today. Should the GCC use these developed centres as its benchmarks?

Or should it look at other examples? The financial centers in Asia have developed depth and sophistication in a very short timeframe. This was largely possible due to the emergence of Asian economic giants such as China, India, South Korea and others. The GCC countries have very high per capita GDP, its SWFs are among the largest in the world, and energy exports continue to provide windfall profits. How much of this wealth can possibly find its way back to the region? What will be the catalysts for the repatriation on investible wealth? With capital



markets still at a nascent stage, will private equity funds play a dominant role in asset management, yet again?

Objectives and Areas of Coverage

The purpose of this Study is to assess the new set of factors shaping the next

phase of regional economic growth and their impact on the future growth and evolution of the asset management industry in the GCC region. The report also assesses some of the challenges and weaknesses that will likely impact the growth of the asset management industry. The underlying discussion centres on specific dynamics of the industry and unique growth drivers. The industry is very young, when compared to other developed and emerging markets. At the same time this young industry is nestled in a region of tremendous wealth. Despite its youth and in the aftermath of the financial crisis, the GCC region's asset management industry has shown signs of maturity and consolidation. The uniqueness of the region necessitates a customized view of the future evolution of this industry.

The Study begins with a perspective on the international asset management industry, with specific focus on recent business trends and strategic shifts in

the industry. It covers enhanced levels of risk aversion of the investors, and the rise and fall of certain asset classes. It discusses the shifts in favour of strict regulatory control and high degree of transparency and disclosure with respect to the activities of asset managers and the impact of these shifts on the profitability and viability of asset management businesses. This section also covers the evolution of financial centers, both traditional and emerging. The story of Singapore is covered extensively, which has rapidly established and consolidated its position along with the traditional heavyweights.

The Study then takes a closer look at the GCC region with an overall description of the competitive landscape, covering key asset classes and investor groups. The Study principally focuses on indigenous asset management firms which primarily target investment in GCC's assets. The diversity and extent of wealth being managed for the investors in the region is extensive and global. Our focus is home market and its prospects to become a sizable and mature industry. The report takes a closer look at how various asset classes have emerged in the region over the past decade. A number of indigenous asset managers have managed to become players of international stature and built world class teams. The Study also looks closely at the various

investor groups and how they are likely to shape

The GCC asset management industry has tremendous potential to graduate to the next level of sophistication

the asset management industry.

The last chapter of the Study presents a blueprint of growth for the GCC's asset management industry. The GCC region holds significant promise for the asset management industry. The specific dynamics of the GCC region necessitates a home-grown and customized approach. The industry has tremendous potential to graduate to the next level of sophistication, and with a defined niche among the global financial community. The GCC region is experiencing unprecedented economic growth, and it will take some unprecedented measures to unleash the growth potential of the GCC's asset management industry.

The asset management industry is a very important nerve centre of any growing economy. A sophisticated asset management industry plays a key role in helping companies unlock their latent value. It also serves as a catalyst for efficient capital allocation by directing investment towards the most viable economic assets. It is a key conduit in attracting foreign capital into an economy.

The ability of the GCC economies to become vibrant and diversified, achieve sustainable growth and attract foreign direct investment will be directly linked with the development of its asset management industry and financial centres. Asset management in the GCC can play a key role in improving the global competitiveness of the region.

II

Key Findings and Conclusions

The last decade has seen the emergence of a diversified asset management industry in the GCC region. It is fast developing and undergoing rapid evolution. Although small by global standards, what is remarkable about the industry is not so much its absolute size but the remarkable pace of its growth and sophistication, and its resilience to the global financial crisis of 2008. Despite the severe jolt from the financial crisis of 2008, the industry managed to consolidate and move on. Over the next ten

years, the industry's tenacity and growth will be tested by the industry's ability to; (i) capitalize on lessons of the last decade, (ii) assess the regional and global shifts in capital and investment flows, and (iii) restructure and adapt its economic models, operational frameworks, and investment propositions.

A. Duality of the GCC's Asset Management Industry

Within the GCC region, asset management can be segregated into

two main buckets. One is public markets linked asset management industry and the other is private equity linked management (including venture capital, buyout and infrastructure funds). Both asset classes have demonstrated different growth trajectory, are at different stages of development and will be influenced by very different set of factors going forward.

In most other regions in the world, private equity is either underdeveloped or a small part of



the asset management industry. In the GCC, the private equity industry at US \$15-18 billion is at least as large as the equity mutual funds market, spanning investments beyond the GCC region and covering a broad spectrum of risk classes including venture capital, SME, expansion and late stage, and infrastructure.

i. Capital Markets and Mutual Funds Industry in the GCC

Collectively, all of the markets in the GCC, despite vibrant public and private sectors, are still considered "frontier" markets by global standards. Although most of the GCC countries set up their exchanges more than a quarter century ago, these markets still have to evolve as sizable platforms for capital raising, acquisitions and divestitures.

The development and growth of the mutual funds industry is predicated on the diversity and growth of the capital markets. The mutual funds industry in the GCC region has registered phenomenal growth during the last decade with tripling of Assets under Management ("AuMs") and quadrupling of the number of asset managers. In the GCC, growth in mutual funds' AuMs has traditionally been more strongly linked to growth in market capitalization than to growth in market penetration. A very low penetration of mutual funds vis-à-vis the market capitalization (at only 2.5%) indicates that the

GCC mutual funds have challenges in building portfolios that allow for diversity. The industry faces a number of limiting factors and challenges which if not addressed can limit AuM growth to market capitalization and hamper growth in market penetration, thereby making growth one-dimensional. The most obvious challenges include limited number of active stocks (coupled with low free float), concentration of market values in few sectors (financial services and real estate), and mutual funds' home bias. There is a risk that the mutual fund industry could remain trapped in its current space and may be severely constrained in its ability to generate AuMs from new investors, particularly foreign investors.



Going forward, a recovery in the market may generate renewed activity. What is critically needed is a pipeline of new IPOs, reducing the level of constraints on portfolio construction.

The mutual fund industry has a key role to play in unlocking the economic potential of the public equity markets.

The fixed income funds are in very early stages of growth and development in the region. However, the underlying market for fixed income securities is sizable. A number of various types of fixed income securities are issued in the GCC or by the GCC issuers. Despite this increased activity, very few bonds and sukuks are listed in regional stock exchanges. Given that there are only a handful of bonds and sukuks listed in GCC exchanges, the possibility of a diversified fixed income fund is practically negligible. Currently the fixed income funds comprise only 3% of the mutual funds' AuMs.

ii. Private Equity Revolution and Birth of an Asset Class

In the past ten years or so, a quiet revolution has taken place in the private equity sector in the GCC. The private equity industry at US \$15-18 billion is almost as large as the equity funds market. It has also grown in sophistication in terms of sectors, spectrum of risk assets and quality of investment professionals.

The era of "blind pool" funds, actively managed by a qualified investment team had already started during the early 2000s when certain venture capital and early stage investment funds were established in the region. The era of PE funds in the GCC region began in the early 2000s, when management teams of what are now Abraaj Capital and HSBC Private Equity Middle East

("HPEME") pioneered this industry in the region by establishing US\$ 100 – US\$ 120 million funds and established the template for the PE industry.

With the successful exit of Aramex in 2004, the first truly PE backed IPO, the PE model was able to demonstrate viability for investors. The period of 2004-2007 signifies proliferation of new PE funds across the region. Successor funds were raised of higher denominations. A number of new first time funds and asset management companies (focusing on private equity) emerged including SWF backed investment platforms. A number of leading international PE firms including Carlyle, Macquarie and KKR established their presence in the region.

The phenomenal growth of this new asset class turned into a PE asset bubble by 2007, signified by asset overpricing (too many players chasing too few deals), high use of leverage, asset flipping, and weak corporate governance standards. However, established PE fund managers maintained a balance in their relationship with their investors and instituted a higher degree of governance and reporting standards. These managers have emerged the strongest following the crash.

The crash of 2008 exposed the fault lines of the PE industry. Fundraising for blind pools became extremely challenging and there was a major shake-up in the industry resulting in closing down or scaling down of a number of PE firms. There was significant asset price deflation and exits through IPOs virtually stopped.

New models of conducting PE business evolved. The 2008 crash

did not prevent certain fund managers from creating a deal flow for their investors and conducting transactions outside of "blind pool" arrangements and on deal specific basis.

There are very strong indications of renewed activity in the PE fund space. Investors, particularly from Asia are looking for new investment propositions and searching for growth assets in the GCC region. Established PE players with a track record of successfully managing their previous PE funds stand a better chance to secure such investors.

Within the broad domain of private equity, the subsets of venture capital and SME funds have also evolved. Although these two subsets may appear similar in terms of risk profile, investment size and nature of play, they are driven by very distinct set of drivers. While the years 2000-02 marked the emergence of the venture capital industry, the years 2010-12 seem to be marking the emergence of an asset management play focused on the SME sector. While the venture capital industry is driven by intellectual property and innovation, SMEs are dependent on people, i.e. the entrepreneurs. Majority of the venture capital funds that have been deployed in the Middle East over the last five years have been in investments in the Levant and North African regions, with deployment in the GCC region being negligible. SME appears to be an emerging asset class with strong support from the public sector. Leading PE players like Abraaj have set up sizable investment platforms to cater to this sector. Its recent acquisition of Aureos Capital, a leading global SME specialised PE firm, is an indication of strategic importance of SME space for a player initially

known for buyouts.

The PE industry is now leaner and perhaps stronger. Barring any tail event, PE stands to become a dominant contributor to the growth of the asset management industry in the GCC region over the next 4-5 years.

B. Islamics – A Fast Emerging Theme in the Asset Management Industry

Over the last 10 years the investment management industry has seen an explosion in the growth of Shariah compliant products. This growth has taken place across asset classes including mutual funds, private equity, and debt instruments (sukuks). Shariah compliant products are expected to continue their upward growth

trajectory over the next few years.

This growth in the number of providers of Islamic funds, increased diversity of Shariah compliant products, emergence of pure play Islamic asset managers, in addition to investment managers voluntarily opting to provide investment opportunities under Shariah compliant structures have all collectively added to the significant growth of Islamic assets under management in the last few years.

C. Current and Emerging Role of GCC's Key Investor Groups

GCC is home to some of the most influential investor groups globally. Sovereign Wealth Funds ("SWFs") from the region are counted among the select sophisticated global investors. The region's HNWIs, including principals of premier family groups are well-known financial investors. GCC region's key investor groups include:

i. SWFs - To be internationally focused: In the past ten years or so, SWFs have become more active in making direct, high value and high profile investments. Following the financial crisis, SWFs from the region seem to have become more active in making direct investments. SWFs will continue to remain globally focused, and their direct role in developing the regional asset management industry will probably remain limited. They could provide a consultative role in setting up good quality

investment teams and world class investment process for government led infrastructure funds

government led infrastructure funds. ii. HNWIs and Family Groups -

Focus on consolidation and

instilling investment discipline:

GCC HNWIs and family groups are among the largest and most significant participants of the regional asset management industry across all asset classes. The larger family offices have in-house dedicated investment teams; the investment teams are typically small, and investment decisions are led by family heads. Whereas, the smaller and mid-sized family groups mostly work through other asset managers or make direct

investments opportunistically. This group of investors faced a number of problems after the financial crisis including impairment of their investment portfolios and severe liquidity crunch.

In order to sustain their investment activities over the longer term however, family offices should look to replicate structures of other international family offices, whose primary role is asset allocation, fund manager selection, and where required, board level activism. They also need to work on their portfolio companies to recoup their investment values and to restore liquidity.

iii. Institutional Investors:

Institutions in the GCC region comprise of central banks, commercial banks, pension funds, insurance companies, and other non-financial corporates. These are the key source of funds for regional private equity funds. Regional institutions may not have a substantial role in building market depth, however once market depth increases they have the potential to participate increasingly and supplement their investments.

International investors represent significant opportunity going forward since they have underweighted allocations to the GCC region for several reasons. At present, they have limited exposure to capital markets and isolated commitments to region's PE funds.

iv. Retail Investors: Retail investors are a significant source of investments and liquidity. Their participation across other asset classes such as equities and real estate funds will be a function of

regulations allowing the participation of expatriates. The high income retail groups (mostly local population) typically utilize the services of wealth managers and private bankers in the region and generally invest in international equities and local assets such as mutual funds. However, majority of the wealth held by retail customers is in the form of cash, bank deposits, and fixed deposits, which demonstrates the large untapped wealth that can be targeted by the regional asset management industry.

Overall, investor configuration in the regional asset management industry is changing. International and regional institutional investors will be main sources of capital for private equity funds, while family groups will progressively join as they iron out their legacy issues and rebuild their liquidity. For mutual funds, retail investors and regional institutions will be the largest participants, while international investors can participate depending on their perception of the markets and possibly subsequent to upgrading of the region's key markets. International investors though are more likely to consider PE investment platforms. Sovereign Wealth Funds will continue to focus on investments in the international markets. However, their role in providing seed financing and advisory support in setting up regional asset management initiatives cannot be ruled out.

D. Perspectives on International Asset Management Industry and Lessons for GCC Financial Centres

Global assets under management exceed US\$ 56 trillion. About one

out of four dollars of investible wealth worldwide (about US\$ 200 trillion) is estimated to be managed by investment managers. The industry has historically been dominated by mutual funds and other related investment products. Real estate investment funds were traditionally considered the only alternative asset class in the asset management industry. The past thirty years or so have seen the emergence of a number of new alternative investment products such as private equity and hedge funds - amongst others.

The year following the global financial crash of 2008 proved to be one of the worst in living memory for the asset management industry – about 20% of the industry's assets under management were wiped out. The situation was further exacerbated by insider trading and accounting frauds that rocked the asset management (particularly, the hedge fund) industry.

Despite all these challenges, the industry has made a remarkable recovery. By the end of 2010, the asset management industry had assets under management back at the pre-crisis level of 2007. With its remarkable recovery, the asset management industry is also undergoing radical shifts which include:

- Global asset managers are increasingly targeting new investor base in Asia, particularly in China & India;
- ► The asset management industry is facing reduction in fees while its operating costs are mounting. Investors are seeking reduction in management fees, market conditions are putting pressure on performance fees and new administrative and compliance requirements are increasing
- ► The global financial crisis of

- 2008 has resulted in a near overhaul of banking regulations in developed markets to avoid a similar crisis in the future.
- ➤ Over the past few years, several activities of the investment banking and asset management industry are progressively being outsourced to low cost locations, such as India.

These shifts have the potential to create opportunities for the GCC region, particularly for its financial centres seeking to play a greater role in global wealth and investment flows. The GCC region shares the key building blocks that have made the Asian centres so successful in asset management. The GCC countries will need to create distinctive propositions for the asset management industry based on their own requirements, policy and economic priorities and business dynamics, especially as the world enters a new phase of economic activity.

E. Emerging Landscape of the Asset Management Industry in the GCC Region - Opportunities and Challenges

The GCC region has substantial wealth and available capital. However, in order for the GCC asset management industry to grow, the region needs to create diversified opportunities for deployment of capital, and an organized group of well-established and credible asset managers who can facilitate capital allocation and generate significant risk-adjusted returns for investors.

i. Private Equity - Expansion and Growth Capital

The region now has a "PE memory". One of the key messages from the legacy of the first crisis in the PE industry is that the industry in general has to develop an industrial

approach to investments rather than relying on financial engineering to generate returns. Investors will judge propositions of future funds and fund managers on the credibility of value creation case.

Opportunities Landscape and Key Areas of Focus:

- ► PE managers with a successful track record, including exits will draw more attention than first time funds.
- ➤ Valuations have returned to more reasonable levels before the financial crisis. Besides, PE funds that invest at the early stage of the economic cycle have a greater prospect of riding the business cycle.
- ➤ Sector specialization, hybrid PE structures, transaction-by transaction PE structures are some of the new formats that have already started evolving.
- ► First time funds would need to be much smaller with well-defined use of management fees.
- Private equity firms with good track record and international standard corporate governance can generate interest from international investors.
- There will be increased focus on transparency, reporting and corporate governance.

 Investment managers that demonstrate commitment to remain tightly focused on investment mandates will garner greater interest. For new funds, investors will seek greater board level activism.

Challenges:

► With investor fatigue setting in place, the investors are by and large averse to blind pool propositions. It is imperative to

- overcome the crisis of confidence. Indications of Asian investors' interest in the GCC PE industry is an encouraging sign and can be the beginning of resurgence in fund activity in the region.
- A majority of PE fund managers are working vigorously on long drawn process of monitoring of their portfolio investments with an aim to return monies to investors.
- ▶ PE fund managers are facing pressures on their management fees structures globally. The managers must rationalize their cost structures.
- ► An overall improvement in regional expertise and staffing experienced professionals will be required to overcome the crisis of confidence.
- A slowdown in the IPO activity has effectively taken away one of the leading exit options for the PE funds. Reliance on trade sale has led to longer holding periods and thus affected overall expected returns on investments.

ii. SME Funds:

Establishment of SME funds offer a real opportunity to investment managers. There is huge funding gap. The banking system, on an overall basis, has not been able to bridge this gap in this important sector of the economy. SME funding requires a distinct set of investment discipline, investment horizon and return expectations. The key success factor in managing viable SME platforms is to have on the ground local teams working on identifying the appropriate opportunities and managing investments.

Opportunity Landscape and Key Areas of Focus:

- ► There is merit in being focused and having on the ground presence. SME investments require more time and even more personal interaction with the key persons.
- ► Funds running efficient operations through standardization of key functions (deal generation, investment analysis etc.) and outsourcing some of the non-core activities can have a competitive advantage.
- ► Funds operating in this space will need to have focused investment propositions.

 Midcap space can be a more viable entry spot.
- ► Cheaper funding may be available from government and multilateral organizations.

Challenges:

- ► Generating adequate risk adjusted returns is one of the most quoted challenges related to investment in SMEs.

 Investors will typically expect a return higher than a PE fund on SME transactions.
- Lack of corporatization and governance needs to be embraced when taking on SMEs.
- Exiting an SME investment can definitely be tough. At the moment, there are no secondary markets for trading stakes in SMEs. However, most of the SMEs are in the feeder industries and thus can become potential candidates for acquisition by companies in related domains.

iii. Infrastructure Private Equity

The GCC region has already been introduced to the infrastructure private equity as an asset class. Going forward, this asset class can be an effective tool for delivering financing to the infrastructure projects across the region.

Opportunities Landscape and Key Areas of Focus:

- Infrastructure Fund
 Platforms: Combination of
 sizable infrastructure
 investment opportunities in the
 GCC, availability of substantial
 capital (particularly from the
 public sector) and presence of
 infrastructure fund
 management expertise in the
 region can be a potent
 launching pad for undertaking
 public sector led infrastructure
 funds.
- ► Private Investors Led Independent Infrastructure Funds: Case for independent infrastructure funds is expected to retain its compelling proposition.

Challenges:

The infrastructure funds' development in the GCC will depend largely on the public sector's approach towards public private partnerships and support from multilateral organizations. Private capital, including that of HNWIs from the region needs to be attracted in these initiatives.

iv. Mutual Funds:

Mutual Funds will remain one of the dominant segments of the GCC asset management industry. Going forward, it will most probably remain the largest. However, in terms of its overall significance in the economic growth of the region, its role at best will be a byproduct of the developments in other sectors of the economy and other segments of the asset management industry.

The mutual funds industry will definitely get a boost from "promotion" of the Gulf markets to emerging status. In addition, renewed economic activity and a strong first quarter this year has made companies dusting off their IPO plans, which got shelved during the 2008 crisis. A combination of these events can provide strong impetus to growth in mutual funds AuM.

There are no apparent challenges to the mutual fund industry other than lack of depth and diversity in the stock markets.

v. Fixed Income Funds:

The market for underlying assets of Sukuk and Bond funds is robust and sizable. Despite its strength, it is difficult to conceive a vibrant market for sukuks or bond funds due to several structural challenges and dominance of the banking sector in providing debt financing to corporates.

vi. Real Estate Funds and Real Estate Investment Trusts:

The region's investors have a very strong preference for real estate. The real estate boom in the UAE and some other countries in the GCC demonstrate regional demand for REIT's underlying assets.

F. Way Forward and Areas of Focus for Policy Makers and Regulators

The asset management industry and capital markets are central enablers in achieving capital flows and unlocking latent value in assets. In order to facilitate this growth process, or rather to create an enabling environment for growth;

certain high level strategic steps are required to be taken. These include:

i. Attracting Foreign Investors and Fund Managers: There is a significant opportunity for the GCC to attract foreign investors and fund managers from across the globe. As for fundraising, the region has to work on making structural improvements with respect to transparency and corporate governance issues. This will facilitate reversing the underweight allocation by international investors. Asian investors, specifically from China, are keen to consider investment propositions from the region. Established fund managers should promptly capitalize on these opportunities.

ii. Building Ecosystems: The GCC countries need to build ecosystems, comprising key stakeholders and participants. The region has made excellent progress with respect to financial regulations, specifically relating to asset management firms and capital markets. The regulators need to work on instituting corporate governance frameworks. A broader buy-in from the State will be a prerequisite to strengthen the arms of the regulator.

iii. Reforming Corporate Laws: Corporate laws, specifically related to ownership are opaque. Although

there have been significant improvements in the financial and capital market regulations, commercial and corporate laws have not moved in step. Perhaps, the biggest constraint in the growth of the asset management industry is the issue of opaque regulations relating to foreign ownership. At present, the GCC countries are at varying levels of transition to a 100% foreign ownership model. Given lack of flexibility in the corporate laws and the opaqueness of ownership, asset managers have had to devise ways around these issues. However, in an increasingly global financial world, in order to keep up with the other emerging financial centres and to facilitate long term growth of the asset management industry, GCC's on shore corporate laws need to have appropriate revisions. A unified regulation (in each country) and legally enforceable ownership model will remove a big hurdle in foreign investments.

iv. Creating a Shariah Hub: The demand for Shariah compliant products is expected to continue to rapidly grow and the GCC investors are expected to be the biggest holders of Islamic products. The latent demand for Shariah compliant products is sizable and yet to be explored. The demand is

not limited to GCC investors. Muslim investors all over the world are increasingly seeking Islamic investment products. The financial centres in the GCC are naturally positioned to capitalize on this space and become a hub for Islamic asset management for investors worldwide.

v. Public Sector Commitment:

Public sector needs to sponsor and nurture SME and venture capital industries. The public sector can attract best in class talent to support the development of these two sectors. SME and venture capital funds can operate much more efficiently if investment management is undertaken by good quality investment teams. Similarly, governments can also establish infrastructure funds in collaboration with the private sector. Even if capital commitment is not involved, closer discussions with the asset management industry would be beneficial for policy makers.

vi. Multiple Centre Propositions:

The GCC region already has multiple financial centres. Each financial centre is capable of building its own unique value proposition. The market is still large enough to accommodate multiple financial centres. The major financial centres would need to find ways to complement each other.

III

Chapter 1: Evolution and Business Dynamics of the Global Asset Management Industry

A. Overview of Asset Management Industry and Global Trends

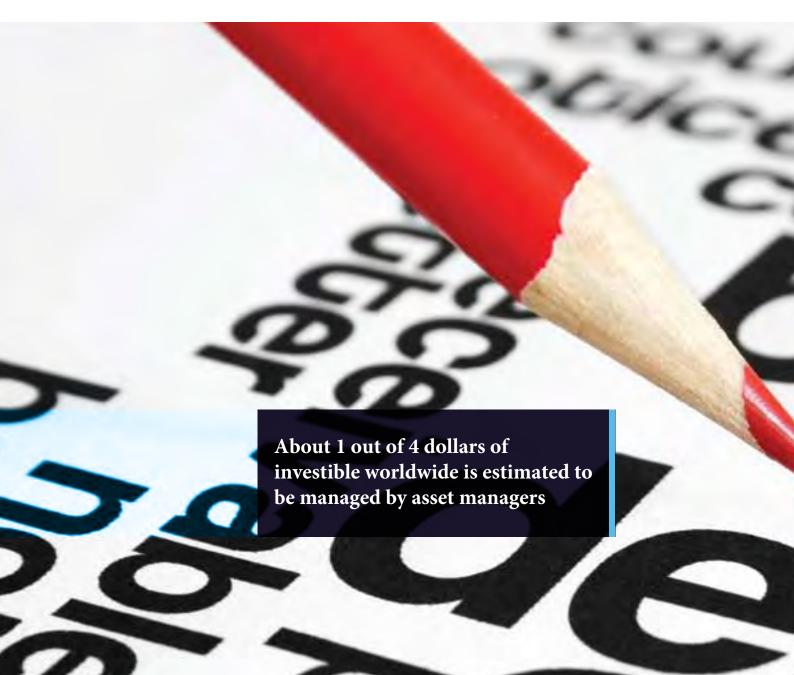
i. Growth & Development of the Global Asset Management Industry

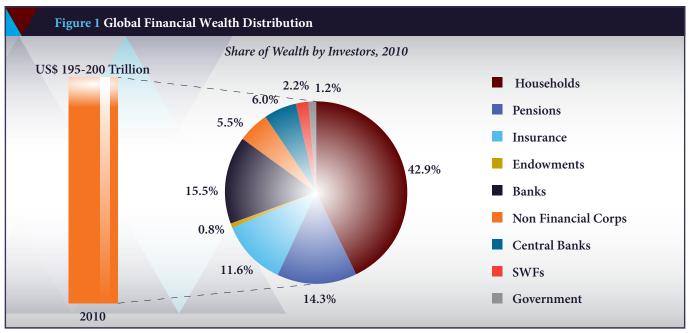
The global asset management industry has grown rapidly over the past 30 years, not only in size but also in sophistication. Global assets under management exceed US\$ 56 trillion¹. About one out of four dollars of investible wealth worldwide (about US\$ 200 trillion)

(Figure 1) is estimated to be managed by investment managers. The more esoteric components of the asset management industry have grown even faster. For example, the hedge fund industry, which was under US \$200 billion till the year 2000, grew by about ten times to US\$ 2 trillion by 2011².

The asset management industry has several sub components such as mutual funds, private equity, and hedge funds, which vary widely in size, investor profile, investment thesis, manager's remuneration structure, governance and compliance. However, the central theme of the industry remains the same: skilled investment managers are given funds by investors to manage within a defined mandate. Their performance is judged on their ability to deliver superior returns on the investments (after adjusting for fees, costs, and relevant risks) than what investors would otherwise earn by investing directly.

The industry has historically been





Source: The Economist, Bloomberg News, Markab Research & Analysis

dominated by mutual funds and other related investment products.

Real estate investment funds were traditionally considered the only

alternative asset class in the asset management industry. The past



thirty years or so has seen the emergence of a number of new alternative investment products such as private equity and hedge funds – amongst others.

management industry.

ii. Impact of the Global Financial Crisis on the Asset Management Industry

The GFC wiped out a fifth of the industry's AuMs, which were back at the pre-crisis levels at the end of 2010

The 80s saw the emergence of private equity or the leveraged buyout ("LBO") industry (Figure 2). In the 90s, as globalization started taking roots, hedge funds started making their appearance, while the internet or dotcom boom of the late 90s gave birth to the venture capital industry. By 2008, the asset management industry had become a large, sophisticated, diverse and global industry. It was considered the engine of the non-banking financial system and dominated the global wealth

The global financial crisis of 2008 was not precipitated by the asset management industry. It is true that at the

epicentre of the crisis were investment banks such as Merrill Lynch, Lehman Brothers, and Bear Stearns among others, which also managed investments; however this was largely a banking crisis.

The year following the global financial crash of 2008 proved to be the annus horribilis for the asset management industry - a fifth of the industry's assets under management were wiped out.

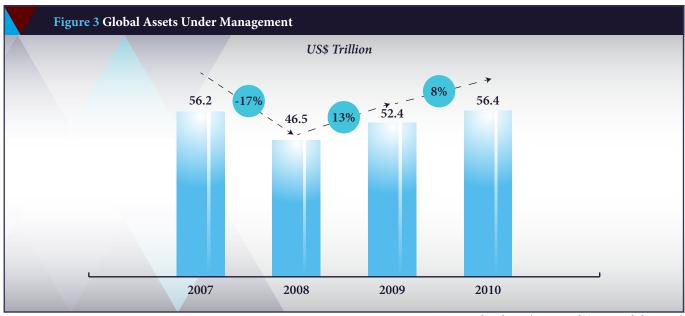
Exacerbating the crisis were issues of insider trading and accounting frauds that rocked the asset

management (particularly, the hedge fund) industry. Bernard Madoff (a former Chairman of NASDAQ) was arrested in December 2008 for running a Ponzi scheme and defrauding investors to the tune of US\$ 65 billion³. In October 2011, Raj Rajaratnam, who ran Galleon, a US\$ 6.5 billion hedge fund, was sentenced to 11 years imprisonment for insider trading. More arrests have been made and the industry is being scrutinized more closely for the past four years.

Yet the industry has made a remarkable recovery. By the end of 2010, the asset management industry had assets under management back at the pre-crisis level of 2007 (Figure 3). True that stock market recovery helped but the growth in AUMs also demonstrated the confidence that investors had quickly regained in the asset management industry.

The asset management industry has had a history of resilience and ability to reinvent itself following each crisis. The junk bond crash of

Industry Growth	 Private Equity The rise of private equity Emergence of KKR and their first ever buy-out in 1984 Acquisition of RJR Nabisco by KKR, the largest leveraged buy out in history at the time 	 Hedge Funds The rise of hedge funds on the back of double digit growth of Tiger Funds Mutual fund asset managers increasingly shifted focus to managing hedge funds in early 90s 	 Venture Capital Internet boom Rapid rise of the venture capital industry Thousands of start ups in Silicon Valley funded by VCs and Angel Investors 	 Real Estate Real estate boom Easy availability of bank finance Sophisticatedly structured investment products such as derivatives, options, etc.
	1980s	1990s	Late 90s - Early 2000s	Mid 2000s - 2008
Industry Crisis	• Junk bonds crisis in 1987 took the steam out of LBOs	 Asian crisis in 1997, followed by collapse of several hedge funds; Tiger Funds meltdown in 2000 	• Dot com crisis	• Sub-prime mortgage crisis → Global financial crisis



Source: Bloomberg, The Financial Times, Markab Research

the late 80s was a disaster for the LBO driven private equity industry, yet the industry was able to turn itself around and continues to grow since then. The hedge fund industry, which was at the centre of the storm during the Asian crisis, has grown ten times between 2000 and 2010. The dotcom crash drove many venture capital funds out of business but within a few years the industry was pouring vast amounts of money into exciting startups and early stage companies.

The asset management industry is now reshaping itself for the next growth phase.

iii. Fundamental Shifts in Global Asset Management Industry

With its remarkable recovery the asset management industry is also undergoing radical shifts. These shifts have the potential to create opportunities for the GCC region, particularly for its financial centres seeking to play a greater role in global wealth and investment flows.

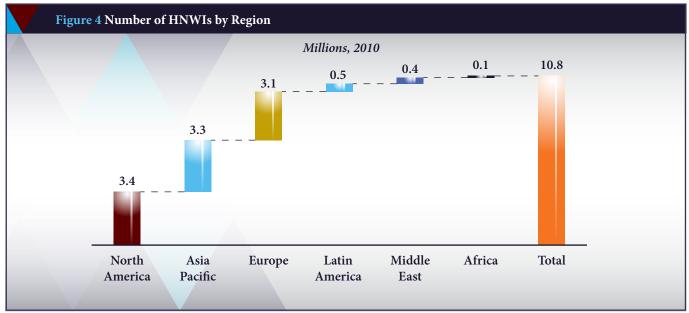
These shifts include the following:

 Tapping New Sources of Wealth and Investment – an Eastward Shift

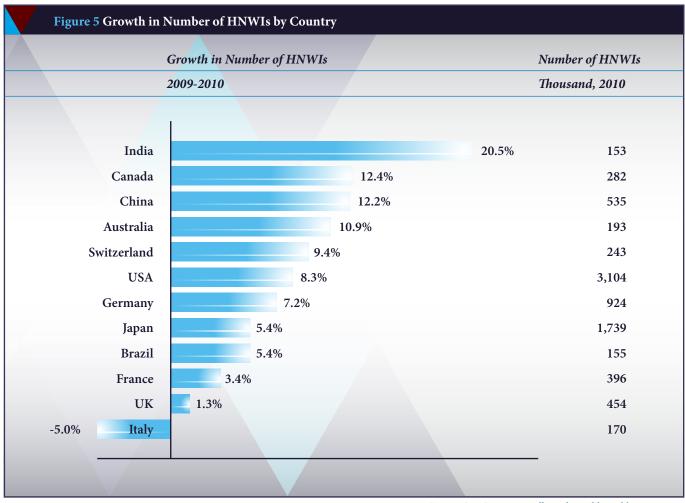
Global asset managers are increasingly targeting new

investor base in Asia, particularly in China & India. China now has more billionaires than any other country in the world (except the USA)⁴, The Asia Pacific region has now surpassed Europe in terms of the number of HNWIs⁵, and almost equals North America (Figure 4).

Asset managers are targeting the large and rapidly growing middle class population of China and India that require investment products and financial advice for retirement planning. India has the highest growth rate in number of millionaires compared to any other country (Figure 5).



Source: Cap Gemini Merrill Lynch World Wealth Report 2011



Source: Cap Gemini Merrill Lynch World Wealth Report 2011

Asset managers are expanding into these markets with a long term view on their growth and profitability. A number of players have entered these markets, either independently or through joint ventures and other partnership models. In China, for example, 70% ⁶ of the retail deposits are controlled by the four state-owned banks, and major international asset managers are looking to build partnerships with them in order to gain access to their large captive customer base. For example, Credit Suisse's asset management has a joint venture with the Industrial and Commercial Bank of China, and was the first player in the market to offer a bank sponsored mutual fund to customers.

India shares many of the attributes that makes China such an attractive market for asset managers, such as a rapidly growing middle class and wealthy population, growing economy, strong equity markets, declining interest rates, and high savings rates. A number of international players are already present in India, including Blackrock, the world's largest asset management firm that started its operations in India in 2010.

Revenue Squeeze and Cost Pressures

The asset management industry is facing reduction in fees while its operating costs are mounting. Investors are seeking reduction in management fees, market conditions are putting pressure on performance fees and new administrative and compliance requirements are increasing costs.

Research by Prequin shows that management fees for new buyout funds are being pressured downward from 2% to 1.7%. At the same time, performance fees (or carried interest) are being impacted by longer holding periods for underlying assets. Hedge funds needed US\$ 75 million in assets to sustain themselves, now they are said to need at least twice as much because of higher administrative and compliance costs.

The mutual fund industry (the largest segment of the asset management industry) is seeing increasing competition from the potentially disruptive Exchange Traded Funds ("ETFs"). ETFs' administration cost is 0.55% per annum, less than half the administrative cost of running a mutual fund⁷. Though still relatively small at US\$ 1.2 trillion, the ETF industry globally has trebled in size between 2005 and 2010.

As a result, the asset management industry, particularly the small and mid-sized players, are critically examining their cost structures and seeking ways to reduce them.

Changing Political & Regulatory Environment in North America and Europe

The global financial crisis of 2008 has resulted in a near overhaul of banking regulations in developed markets to avoid a similar crisis in the future. Regulations such as Basel III and others have been put in place over the past four years.

While many of these regulations are badly needed for restoring the health of the banking system, asset managers are becoming concerned about political overreaction and public sentiment. Movements such as Occupy Wall Street (OWS), which began in September 20118 are examples of the public perception about the industry and there are concerns about political ramifications.

More disturbing to investment managers is the possibility of new

The Asia Pacific Region has surpassed Europe in terms of number of HNWIs, and almost equals North America

taxes. In February 2011, the European Commission launched a formal consultation on new forms of taxation for the financial services industry in Europe. One of the proposed taxes of the commission that is already courting controversy is called the 'financial transactions tax', which will place a

charge on transactions between financial institutions⁹.

In addition to this.

immigration laws in the UK and other European countries have also been tightened resulting in limiting the ability of these markets to recruit skilled professionals from global markets.

• The Impact of Outsourcing.

Over the past few years, several activities of the investment banking and asset management industry are progressively being outsourced to low cost locations, such as India. Technology back office, research and product development are some of the key activities being shifted.

While the large investment banks and asset managers have their own in-house teams, there is a big pool of talent available for outsourcing. New asset managers can set up businesses close to their customers and get much of

> the back office work done in a low cost location.

The shifts in the asset management industry are

fundamental and long-term. Lower taxes (and costs), proximity to new sources of wealth and investments and the ability to hire and deploy global talent are driving the growth of financial centres in Asia.

The trend is set to accelerate. The financial centres in Asia are growing in sophistication and, in

Over the next few years, Asian financial centres will be able to add more asset management desks than other global centres

many ways, better positioned to compete with the traditional ones. For example, if a firm has its customers in Asia and can set up a back office in India; Singapore, with its sophisticated regulations, lower tax rate and open immigration policies may be more viable than London, which has higher taxes (and concerns about further increases), tighter immigration policies and a somewhat negative political attitude towards the industry.

It is not to imply that established financial centres will start becoming 'ghost towns'. However, more options for new asset managers and desk relocations by existing ones all add up incrementally in favour of Asia. Over the next few years, the financial centers in Asia (and possibly the GCC) may be able to add more asset management desks than some of the established ones.

B. The Emergence of New Financial Capitals

i. Traditional Financial Centers

Historically, London and New York have been regarded as the financial centres of the world due to their unparalleled reputation in terms of the full range of financial services offering, talent pool, multicultural ethos, regulatory environment, and overall enabling infrastructure. Up until the late 1990s, these two cities were considered the global hubs for financial services in general, and asset management in particular. Other large centres, such as Tokyo with the Tokyo Stock Exchange having a market capitalization of

US\$ 4.1 trillion, are immensely successful, but their listings are predominantly local.

As deregulation and economic growth started to take roots in Asia in the 90s, new financial centres began to emerge on the global scene. Mumbai, Shanghai, Hong Kong and Singapore have emerged as major financial districts attracting global investments. Asia

investible wealth, has three Asian financial centres catering to its requirements at different levels. Shanghai is the local financial centre, more or less dedicated to China; Hong Kong actively caters to China and brings much more depth and world class regulatory infrastructure; Singapore is a global marketplace for Asian and international investors and asset managers with an increasing focus on China.

Singapore's growth is built around tax incentives, ease of setting up, and favourable regulations

is now becoming the fastest growing and most hotly competed region in global asset management. This growth was evident during the last decade and gained further momentum following the global financial crisis as asset managers looked to target customers in other markets besides those in North America and Europe.

Rapid economic growth, an emerging middle class, large savings reserves, and increasing interest from international investors are the main drivers of the rapid growth of the Asian asset management industry.

International firms are increasingly setting up operations in locations such as Hong Kong and Singapore, which have emerged as the most attractive financial centres in Asia, largely due to their overall infrastructure, regulatory environment, tax incentives, and their proximity to China and other Asian markets.

ii. China &Other Asia - a Tale of Two Regions

China, with its phenomenal growth, both in terms of economy and

Hong Kong's role as a global financial hub was already well-established well before it was handed over by the British to China in 1997. It already had talent pool, world-class

regulations, global investor base, and financial depth in place. Under China's 'one country, two systems' policy it has continued to hold this position. Hong Kong is increasingly complemented by Singapore, which also caters to the rest of Asia.

Other financial centres, though attracting foreign direct investments globally, have built investment and asset management industries mainly focused on local portfolios. These include Mumbai, Tokyo, Seoul, Jakarta, Kuala Lumpur etc.

iii. The Singapore Story

Singapore is a small country of 5 million people. It has little natural wealth and a small manufacturing base. Yet, it is considered one of the most well-established global hubs for the asset management industry. Singapore's growth as a global asset management centre has been built around a few key principles, which include tax incentives, ease of setting up businesses, favourable regulations, and the key advantage of providing access to China and other fast growing Asian markets.

Specifically these include the following:

- Top quality public infrastructure;
- Strong legal system;
- High standard of professional support;
- Tax incentives;
- Stable regulatory environment;
- Professional business environment;
- Low bureaucracy;

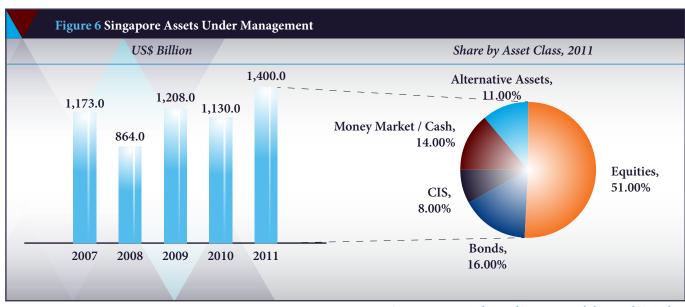




- Growing access to skilled local talent;
- Advanced communication infrastructure;
- Access to Asian markets.

This enabling infrastructure makes Singapore particularly attractive to

asset managers (Figure 6). Licensing requirements have been simplified for asset managers, making it very easy for them to set up shop in



Singapore. Singapore's tax regime, which allows offshore funds to be exempt from tax, is one of its most important drivers of growth as an asset management hub. The offshore status is available for a variety of structures including companies, limited partnerships, mutual funds, and trusts enabling a number of options for traditional and alternative investment strategies for international asset managers. Its tax exempted offshore funds permit ownership of private companies, which has resulted in significant growth of private equity and real estate funds in the country. Singapore is now also attracting hedge funds by developing

regulations catering to the hedge fund industry.

With a regulatory infrastructure supporting all the key segments of the asset management industry, Singapore has significantly enhanced its reputation as a global centre.

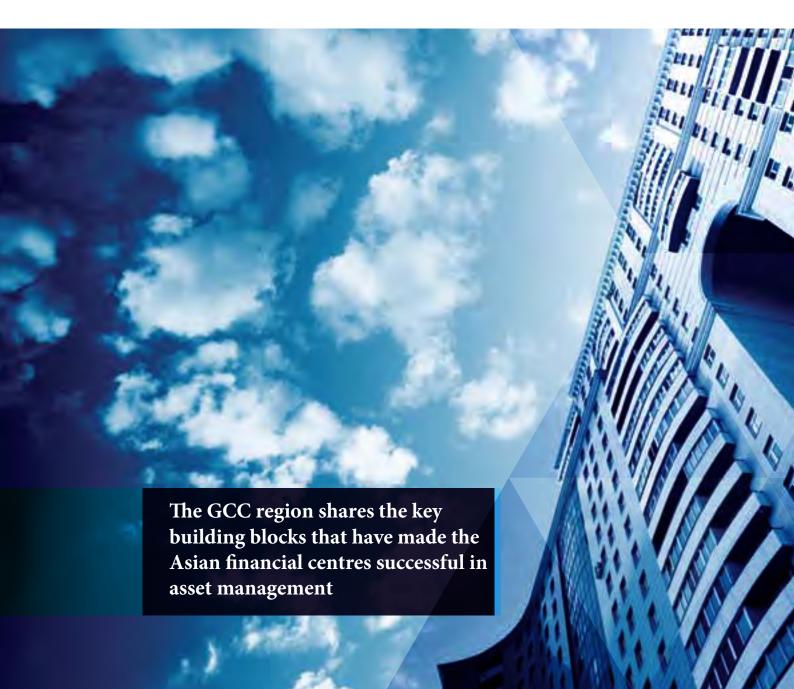
iv. Implications for the GCC

The emergence of new asset management hubs in Asia represents a key departure from long held historical traditions. Business imperatives, such as proximity to investible wealth, simplified regulatory regime and business friendly tax environment have contributed to the success of

Asian global centres such as Singapore and Hong Kong.

The GCC region shares the key building blocks that have made the Asian centers so successful in asset management. The GCC region is a wealthy economy with a combined GDP of US\$ 1.2 trillion; Qatar with a GDP per capita of approximately US\$ 90,000 has the highest GDP per capita in the world. Additionally, the other GCC states Saudi Arabia, Kuwait, UAE, Oman, and Bahrain also rank in the top 50 countries with the highest GDP per capita worldwide.

The economic success has cascaded into the economy in terms of



surplus investible wealth. The number of HNWIs in the GCC is approximately 400,000, about three-quarters of the number of HNWIs in China. Even without accounting for the ultra-rich sovereign wealth funds ("SWFs"), the GCC region's investable financial wealth stands at a sizeable US\$ 2.1 trillion¹⁰.

The favourable tax environment in the GCC region is another key building block for attracting the global asset management industry, especially at a time when the industry is under cost pressures.

The region also provides a favourable labour policy structure

where by the workforce can be recruited from all around the world, which contrasts sharply with the increasingly

The GCC region will have to develop distinctive propositions for the asset management industry to attract them to this region

restrictive immigration policy in Europe. The ability to attract global talent is a key competitive advantage in a knowledge based industry, such as asset management.

In the past few years significant progress has been made in this direction. Saudi Arabia's Capital Markets Authority ("CMA") has been streamlining the regulations for licensing, listing and foreign participation in Saudi Arabia. Dubai and Qatar have established Dubai International Financial Center ("DIFC") and Qatar Financial Center ("QFC") respectively based on international law and best practices. Bahrain has positioned itself as an attractive destination for domiciling funds (including private equity funds) as well as a hub for Islamic banking and finance.

The new dynamics of the global asset management industry provide the region with distinctive opportunities. China's example proves that several financial centers can operate successfully, provided that they complement each other. Having the building blocks in place, while WE LE LI necessary, is not sufficient for success. Successful financial centers bring together investors, asset managers, equity and debt issuers, regulators, advisors, lawyers, auditors, technology providers and a host of other players within a common cluster. Globalization, it seems, is creating new models of proximity. The GCC countries will need to create distinctive propositions for the asset management industry based on their own requirements, policy and BATTAN STATE OF THE STATE OF TH economic priorities and business dynamics, especially as the world enters a new phase of economic activity.

IV

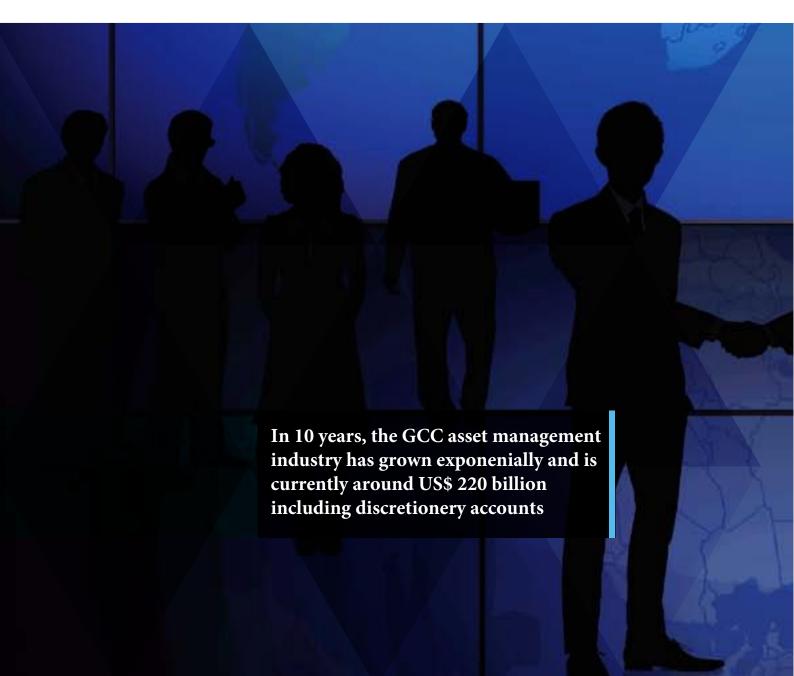
Chapter 2 Section A: Current and Emerging Landscape of Asset Classes in the GCC – Mutual Funds

By global standards, the asset management industry in the GCC is small. Taking together mutual funds, private equity funds, real estate investments and managed accounts, the industry is around \$220 billion in size. What is remarkable about the industry is not so much its absolute size but the remarkable pace of its growth and sophistication, and its potential to rebound from the global financial crisis of 2008.

By all accounts, the asset

management industry in the GCC is in early stages of development and undergoing a rapid evolution. At the turn of this century, the asset management industry was negligible in size, not more than possibly a few billion dollars. The last decade has seen the emergence of a diversified asset management industry. Growth during the early part of this decade was phenomenal and at times explosive. The growth trajectory got a sudden jolt during 2008-09, when the impact of global financial crisis eventually struck the

GCC's financial sectors. The asset management industry, however, has managed to consolidate and move forward. The next decade will test the industry's ability to (i) capitalize on lessons of the last decade, specifically drawn from the impact of the global financial crisis (ii) assess the regional and global shifts in capital and investment flows and (iii) restructure and adapt its economic models, operational frameworks, and investment propositions to take advantage of new and emerging opportunities.



This chapter covers discussion on various key sectors or asset classes of the GCC asset management industry; their beginnings and current state, key forces at work, and a perspective on overall significance of these asset classes on the size and growth of the asset management industry.

Asset management is not a 'one size fits all' industry. In the GCC, there are two active asset classes within the industry; (A) Mutual funds (including equity and fixed income funds) and (B) Private Equity and other alternative assets. Mutual funds are by and large, a function of the size and growth of the regional capital markets, whereas private equity and real estate investments

are largely unrelated to public markets. Investment management of alternative assets is driven by a very different set of dynamics, compared to mutual funds.

Owing to GCC's affinity with Islamic finance the asset management industry has made significant progress in the area of Shariah compliant funds, particularly in Saudi Arabia. Despite several challenges, it is expected that asset management products with Shariah compliant attributes will enjoy a distinct appeal for the investors. The size of the industry, compared to that of the conventional is relatively small and is being developed rapidly. There is a very large latent demand for

Shariah compliant investment products, which will be instrumental in rapid growth of the Islamic asset management industry over the coming years.

This chapter is divided into two sections. Section A discusses the mutual fund industry. This section takes a close look at the mutual fund industry in the region, which is dominated by equity funds. This section also reviews the state of the listed fixed income segment and the state (and prospects) of fixed income funds.

Section B discusses the private equity industry in detail. It also covers other emerging asset classes



China's stock market, even though established in the 90s, has 3.0x the market capitalization of GCC exchanges

such as venture capital, SME funds etc. Islamic asset management is impacting all asset classes. Instead of being broken into two sections, Islamic asset management is discussed at the end of Section B of this chapter.

A. GCC Capital Markets – Young and Emerging

i. GCC Capital Markets' Evolution

The stock markets in the GCC region, despite their current lack of depth, liquidity and diversity, can still be considered promising and emerging.

It is generally argued that most of the established and active stock markets have a very long operating history, coupled with higher degree of sophistication in traded instruments. The stock exchanges of London and New York pre date the two world wars and the US Great Depression. Within the MENA and South Asian region, the Bombay (now Mumbai) Stock Exchange, established in

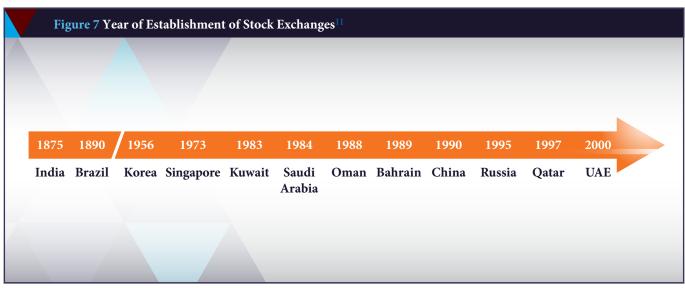
1875, is perhaps the oldest (Figure 7). It is also now the most active and sophisticated stock market in the entire Middle East North Africa South Asian ("MENASA") region.

However, several major stock exchanges are relatively new.
Notable among stock exchanges that are new, yet large, are the Chinese (Figure 8) and Russian stock exchanges. Both were established following the collapse of the central planning model. Private capital and asset ownership in Russia and China was at a very early stage in the 90s. Yet, they surpass the GCC stock markets (combined) in size, depth, liquidity, market capitalization and sophistication.

Collectively, all of the markets in the GCC, despite vibrant public and private sectors, are still considered "frontier" markets by global standards. Although Kuwait, Saudi Arabia, Oman and Bahrain set up their exchanges

more than a quarter century ago, the activity in these stock markets over the years cannot be considered a reflection of economic activities in respective countries (the ratio of market capitalization/GDP is significantly lower than that of the developed markets where market capitalization/GDP is far higher than 100%). Stock exchanges in the UAE and Qatar were established near the turn of the century during an era where technology and sophistication in traded financial instruments have become hallmarks of the modern stock exchange.

Despite some of the regional markets being more than 30 years old, these markets still have to evolve as sizable platforms for capital raising, acquisitions and divestitures (Saudi Arabia, the most active and vibrant economy in the region has only 164 listed companies compared to more than 2,000 in China where the exchange was established 7 years after Saudi Arabia) (Figure 8). This has been a persistent feature of the public markets in the region, so much so that the relative significance of banking, direct investments and private equity funds is much higher than IPOs and the size of equity



Country	Year of Est.	# of Listed Co.	Market Cap. (US\$ Billion)	Market Cap GDP (%)
Kuwait	1983	215	95.6	63.8
Saudi Arabia	1984	146	371.9	80.0
Oman	1988	120	19.6	35.8
Bahrain	1989	44	21.6	90.0
Qatar	1997	43	125.6	81.1
UAE	2000	101	95.5	28.0
Singapore	1973	659	398.4	166.2
China	1990	2,063	4,762.8	81.0
USA	1792	4,279	17,139.0	117.5
UK	1801	2,056	3,107.0	138.3

Source: Stock Exchange Websites, Securities.com, Zawya, World Bank

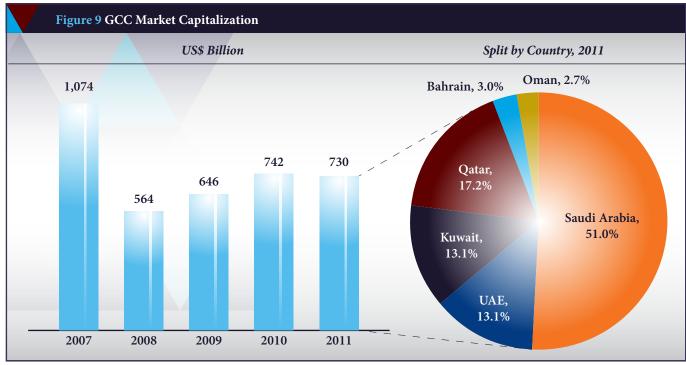
mutual funds in the region.

ii. Dominance and Emerging Leadership of Saudi Arabia in the GCC Capital Markets

Saudi Tadawul has traditionally been the biggest market in the GCC region, maintaining around 50% share in the region's market capitalization over the years (Figure 9). This is not surprising considering the relative size of KSA's economy. Qatar and UAE (UAE has three markets including Dubai Financial Market, Abu Dhabi Securities Market and Nasdaq Dubai) are placed next in the order.

The Capital Markets Authority (CMA) in Saudi Arabia is also actively improving the regulatory framework for listing and corporate governance with a view to building

more depth. The CMA's latest release of new listing regulations is aimed at making Saudi Tadawul an attractive destination for GCC companies. In addition to some other capital markets reforms, this particular initiative is being viewed as a move to further solidify the leading status of Saudi Tadawul in the region, possibly making it a true regional exchange.



Source: Securities.com, Zawya, Stock Market Websites

iii. Early Signs of Emergence of Listed Fixed Income Securities (Bonds & Sukuks)

The GCC stock exchanges trade primarily in vanilla equity securities. There have been some recent listings of fixed income securities (bonds or sukuks) on the exchanges; however equity securities far outnumber the listed sukuks and bonds. Bonds and sukuks are now viewed as a new emerging asset class in the GCC region. Although the overall size of issued sukuks and bonds in the GCC region is quite substantial, only a small fraction of these issues are listed and traded on the stock exchanges. Sukuks and bonds are discussed in greater detail later in this chapter.

capital markets. The mutual funds industry in the GCC region has registered phenomenal growth during the last decade. The number of fund managers has increased fourfold, whereas Assets Under Management have more than tripled during the same period from just over US\$ 11 billion to over US\$ 37 billion by the end of 2011 (Figure 10).

Despite this growth, there are certain characteristics of the GCC mutual funds industry which need to be highlighted in the context of overall market size and maturity:

• Size Relative to Global Industry is Miniscule: The size of the GCC's mutual fund industry in the global context is miniscule. This can be

gauged from the fact that total market capitalization of all the GCC and MENA markets combined is less than the amount managed

by only one of the top ten global asset managers (all of the top ten global asset managers manage assets worth US\$ 1 trillion or more).

• Size Relative to Investible Wealth is Very Small: The region's investible wealth is estimated to exceed over \$3.5 trillion, a large

portion of which is managed by global asset managers. The regional mutual fund managers are managing less than 1% of this pool of wealth.

- Equity Funds are Only Half of the AuMs: Moreover, the GCC mutual fund industry is dominated by money market funds, which constitute 45% of the total portfolio of mutual funds in the region (these funds are predominantly domiciled and traded in KSA), whereas equity funds have a 49% (US\$ 18.1 billion) share. The worldwide value of equity mutual funds is approximately US\$ 12.3 trillion¹² which is over 700 times size of the GCC equity funds industry.
- Assets Concentrated Among Top **Managers:** The top five mutual fund asset managers in the region manage over 55% and top 10 over 70% of the assets. These managers are mostly affiliated with large commercial banks in the region and hence have greater access to institutional and retail investors through the network of their banks. The industry is heavily fragmented at the middle and lower end of the spectrum. This fragmentation has severe implications on the profitability and sustainability of operations of most of these mid to low end fund managers.

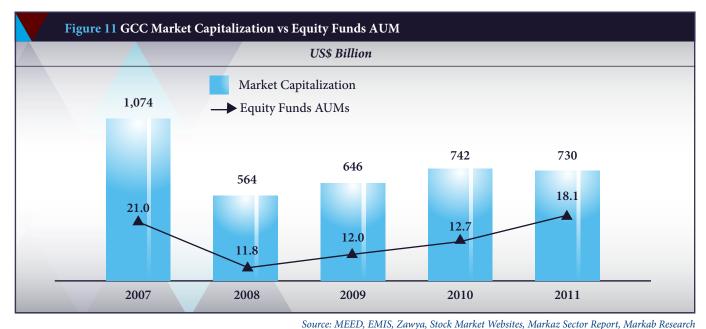
GCC mutual funds AuM have tripled over the last 10 years, growing from US\$ 11 to 37 billion

B. Overview of GCC Mutual Funds Industry

i. Development of GCC Mutual Funds Industry

The development and growth of the mutual funds industry is predicated on the diversity and growth of the

Figure 10 Growth of GCC Mutual Funds Industry						
	2000	2006	2000	2011		
GCC Mutual Funds Industry	2000	2006	2008	2011		
Number of Fund Managers	70			258		
Number of Funds	244	500	605	670		
Assets Under Management (US\$ Billion)	11.4	35.6	24.4	37.0		



• Lack of Depth Discouraging Foreign Direct Investments: The case for holding mutual funds is often stronger for foreign investors than for local investors. Asset managers are often the primary gateway for foreign institutional investors seeking to make foreign direct investments in a country. However; they seek depth and diversity in their portfolios.

A very low penetration of mutual funds vis-à-vis the market capitalization indicates that the GCC mutual funds have challenges in building portfolios that allow for diversity and the investment space for recalibrating their portfolios for them to deliver superior risk adjusted returns.

Moreover, there is currently limited knowledge about or interest about GCC markets within the larger international investment community (this interest may enhance with the graduation of some of the regional markets to "emerging" status).

Growth of the GCC mutual funds industry, not surprisingly, is more strongly linked to growth in market capitalization than to growth in market penetration. Overall penetration of mutual funds remains very low compared to global standards. The equity funds worth US\$ 17 billion in 2011 represents only 2.3% of the aggregate market capitalization (Figure 11). There is a risk that the mutual funds industry could

remain trapped in its current space and may be severely constrained in its ability to generate AUMs from new investors, particularly foreign investors.

ii. Key Forces and LimitingFactors Shaping the Case ofMutual Funds in the GCC Region

Prima facie, the mutual funds industry in the GCC region has registered impressive growth between years 2000 and 2007 with assets under management growing at a CAGR of 18.6% from US\$ 11.4 billion to US\$ 37.6 billion¹³. There was also a brief period during 2004 and 2005, where mutual fund managers managed to earn robust

Figure 12 Number of New Companies Listed in GCC Capital Markets								
Country	2004	2005	2006	2007	2008	2009	2010	
Kuwait	16	30	20	18	21	5	8	
Saudi Arabia	3	4	9	25	16	0	19	
Oman	0	0	28	1	2	0	0	
Bahrain	0	5	2	0	2	4	0	
Qatar	5	2	5	4	2	6	0	
UAE	20	29	2	9	6	0	6	
TOTAL	44	70	66	57	49	15	33	

Source: World Bank, Zawya IPO Monitor, Stock Exchange Websites

fees on the back of the explosive growth of GCC capital markets. In 2005, it was not uncommon for mutual fund managers to earn performance fees of up to 20%; such fees are typically earned by private equity and hedge fund managers, who are considered more active and value creating managers. These fees structure collapsed in the wake of a 2006 mini-crash in the regional markets.

During the same period, i.e. 2004-08, the mutual funds industry had grown significantly driven by growth in market capitalization, new listings, and a proliferation of mutual funds in the market. However, despite this apparent growth, the mutual funds industry is still faced with a number of limiting factors and challenges that need to be addressed for long term growth of the industry. The first quarter of 2012

quarter of 2012 has been one of the strongest in recent history, which has also resulted in improvement of AuMs. The

critical factor to

watch out for will be an overall change in investor sentiment and addition of new scripts of IPO ready regional companies¹⁴.

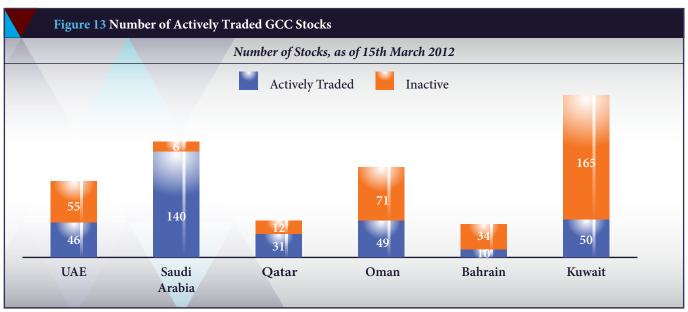
By investing in a mutual fund, investors rely on the ability of the fund manager to generate better risk adjusted returns than they are otherwise able to generate. One of the key prerequisites for the manager in order to deliver these returns is existence of a universe of investable assets, which can be tapped into to create a portfolio consistent with investment objectives of the fund. However, the GCC region has traditionally

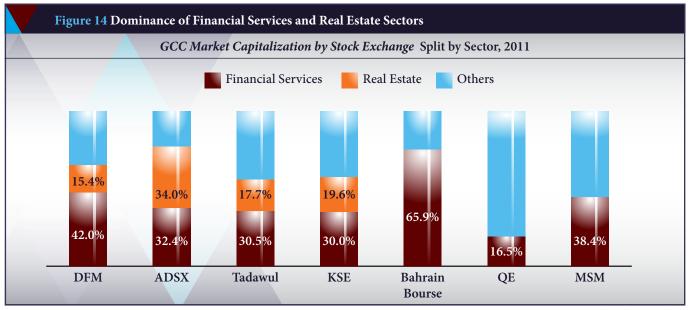
provided limited options for portfolio creation and diversification. Portfolio diversification is sought in terms of geography, asset classes, nature of instrument, or sector; and the GCC region presents limited opportunities on all these counts, due to the following limiting factors. These factors need to be addressed for long term growth of the mutual funds industry in the region. These include:

- Limited Number of Actively **Traded Stocks:** There are a considerable number of inactive stocks in the regional stock exchanges, barring Saudi Arabia and to some extent Qatar where the markets appear to be more vibrant(Figure 13). Lack of liquidity generates considerable constraints for the asset managers in creating a diversified, yet tradable portfolio. The matter of creating a diversified portfolio gets more complicated during an IPO draught, and low levels of floating stock.
- Sector Concentration: GCC capital markets are dominated by financial services firms and real estate development firms, which account for majority of the market capitalization of listed companies (Figure 14). This high dependence on a handful of sectors is an

Limited active stocks, sector concentration, and investor home bias are restraining the development of GCC mutual funds industry

By 2008, capital markets in the GCC had largely collapsed, with market capitalization falling from the peak of over US\$ 1 trillion to just over US\$ 500 billion (Figure 11). Consequently, this massive decline in market capitalization had an adverse impact on new listings on the stock exchanges resulting in IPOs reducing to a trickle. Compared to the high of 2005 when there were 70 new companies listed in GCC capital markets, there were only 15 IPOs in 2009. As can be seen in Figure 12, the majority of IPO activity in the GCC took place between 2004 and 2008.





Source: Stock Exchange Websites

impediment to fund managers' ability to build sector diversified portfolios. Other sectors in the GCC exchanges include industrial, services, hotels & tourism, consumer goods, food, agriculture, telecommunications, and media, but they typically account for a very low volume and low value of trades.

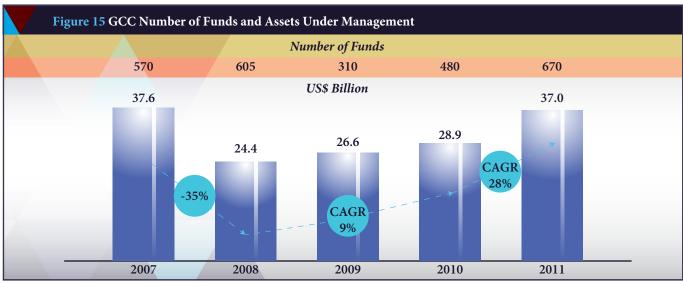
• Home Bias: Investors in the GCC tend to demand 'home stocks' for their local investments. As such, regional activity by investors is surprisingly low. Unlike foreign residents, GCC nationals and institutions from one GCC country are not restricted from investing in other GCC countries. Yet, local GCC investors seem to have a very high degree of home bias in regional portfolio

selection. It is evident from the investor profiles of mutual funds as well as strong relationship between the domicile of the fund manager and geographic scope of the fund (with the exception of Bahrain which offers a higher standard of fund formation and registration regime; a number of mutual funds with regional focus are domiciled in Bahrain).

All of the above limiting factors create diversification constraints for the fund managers and investors. As proportion of nominal GDP, it is still very small in the GCC. In Saudi Arabia it is 4.2%, in Qatar it is 1.8%. In key developed countries, such as Canada, US and Australia, the ratio of Mutual Funds to nominal GDP is between 50-100%.

Going forward, a recovery in the market may generate renewed activity. What is critically needed is a pipeline of new IPOs, reducing the level of constraints on portfolio construction. Some steps are being taken in this direction. For example, new listing rules introduced by the CMA in Saudi Arabia are expected to generate cross listing, thus offering diversification opportunities to Saudi investors in their home market.

The mutual funds industry has a key role to play in unlocking the economic potential of the public equity markets. To achieve growth, other steps are needed. These are discussed in Chapters 4&5 of this Study.



Source: Markaz Sector Report, Zawya, Markab Research & Analysis Current and Emerging Landscape of Asset Classes

C. Fixed Income Funds in the GCC Region

i. Early Stage of Growth for Fixed Income Funds

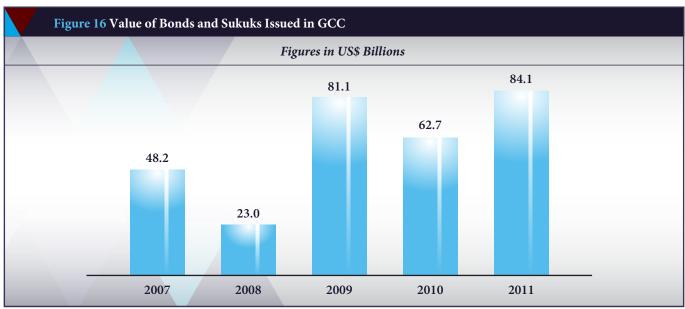
The fixed income funds are in very early stages of growth and development in the region. However, the underlying market for fixed income securities is sizable. A number of various types of fixed

income securities are issued in the GCC or by the GCC issuers. This section takes a broader look at the overall listed fixed income market, since fixed income funds are few and small, currently representing less than 3% of the total mutual funds'assets under management. This section also identifies the underlying reasons for lack of size in this sector.

ii. Growth and Development of the Bonds & Sukuks Industry

The overall industry for bonds and sukuks in the GCC region is fairly robust. In the last three years, total bonds and sukuks issuance in the GCC was US\$ 228 billion, of which US\$ 84.1 billion were issued in 2011 alone¹⁵ (Figure 16).

The GCC region has seen three issuer groups of bonds and sukuks,



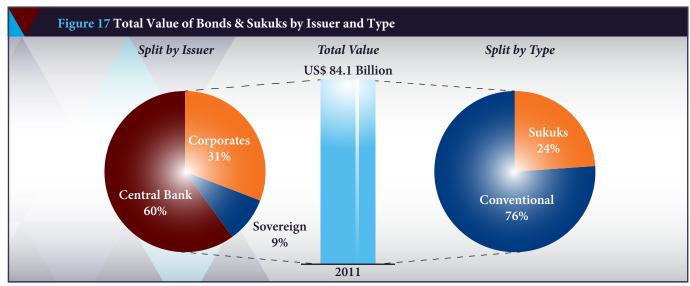
which include the central banks, corporates, and sovereign entities. The corporates primarily comprise of large Government owned organizations and commercial banks, and not pure play corporates unlike in global markets. The central banks accounted for 60%¹⁶

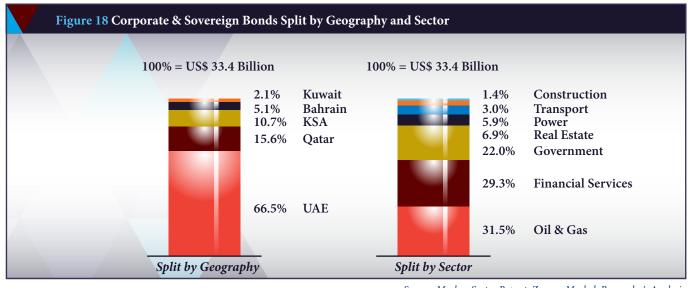
of all bonds and sukuks issuance in the GCC in 2011, which has been excluded from the scope of this study (Figure 17).

The total value of the 49 corporate and 7 sovereign bonds and sukuks issued in 2011 was US\$33.6 billion¹⁷, which is approximately 3%

Source: Markaz Sector Report, Zawya, Markab Research & Analysis ance in of the GCC GDP¹⁸. The under been development of the bonds and sukuks industry is demonstrated by the fact that the value of bonds issued globally is 44.4% of the global GDP¹⁹.

Although there is an active market for bonds and sukuks in the GCC





Source: Markaz Sector Report, Zawya, Markab Research & Analysis

region, which has picked up rapidly after 2010, the market in many ways mirrors that of the syndicated loan market. The only differing factor is that corporate bonds and sukuks allow for the participation of non-banking institutional players.

However, despite this increased activity, very few bonds and sukuks are listed in regional stock exchanges. Out of the 56 corporate and sovereign bonds and sukuks issued in 201120, only a few (6 out of 26 bond issues)21 are listed in regional stock exchanges, largely because GCC capital markets offer

very limited depth for large scale bond issues. Given that there are only a handful of bonds and sukuks listed in

GCC exchanges, the possibility of a well diversified fixed income fund is practically miniscule.

iii. A Long Way to Go

For the bonds and sukuks funds market to become vibrant in the GCC, there needs to be structural reforms in the commercial and

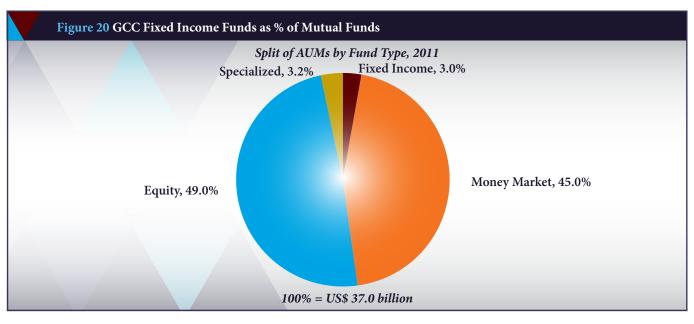
Structural reforms in the commercial and corporate laws are required to develop the bonds and sukuks industry

> corporate laws. At a fundamental level, the difference between bonds and equities is that equities are not subject to default risks. For example, a publicly traded company may not pay dividends for several years, or may consistently be traded below par, yet it will always remain listed on the exchange.

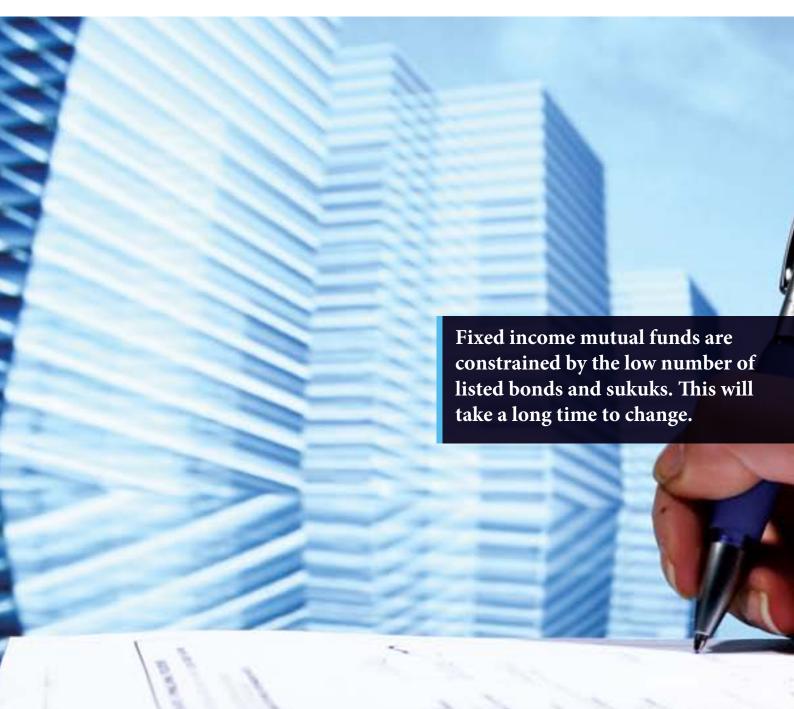
Figure 19 Largest GCC Sukuks & Bonds					
Sukuk Name	Sponsor	Country	Currency	Size (US\$ Mn)	
GACA Guaranteed Senior Sukuk	General Authority of Civil Aviation	Saudi Arabia	SAR	3,999.7	
Nakheel Sukuk	Nakheel Development Limited	UAE	USD	3,520.0	
PCFC Sukuk	Dubai Customs	UAE	USD	3,500.0	
Aldar Properties Sukuk	Aldar Funding Limited	UAE	USD	2,350.0	
SABIC Sukuk II	Saudi Basic Industries Corporation	Saudi Arabia	SAR	2,133.1	

Bond Name	Sponsor	Country	Currency	Size (US\$ Mn)
QCB 2014 Bond	General Authority of Civil Aviation	Qatar	QAR	4,668.0
Qatar Eurobond 2017	Nakheel Development Limited	Qatar	USD	2,000.0
Qatar Eurobond 2022	Dubai Customs	Qatar	USD	2,000.0
Aabar Bond	Aldar Funding Limited	UAE	EUR	1,590.0
IPIC Bond 2016	Saudi Basic Industries Corporation	UAE	EUR	1,590.0

Source: Zawya Bond Monitor, Zawya Sukuk Monitor



Source: Zawya, Markaz Sector Report, Markab Research & Analysis



Issuers prefer to list bonds and sukuks in developed exchanges like Luxembourg

issuers and bond holders. Due to this, issuers prefer to list bonds in developed exchanges like Luxembourg.

- Access to large and diversified base of global investors;
- Robust liquidity and aftermarket support provided by international markets;

Bonds are more complex though, as they need to be backed by a legislative structure to deal with default events. Such structures go beyond the regulatory parameters of financial centres and exchanges. Without legislative structures and corporate laws, the market environment in the GCC region is not conducive for

Other key factors for GCC issued bonds and sukuks to be listed and traded outside GCC capital markets include:

- Established dealer and settlement systems in international exchanges;
- Favourable regulatory structure



IV

Chapter 2 Section B: Current and Emerging Landscape of Asset Classes – Private Equity & Islamics

A. Private Equity – Emergence and Consolidation of a New Asset Class

i. A Quiet Revolution in the Asset Management Industry

In the past ten years or so, a quiet revolution has taken place in the private equity sector in the GCC. In most other regions in the world, private equity is either underdeveloped or a small part of the asset management industry. In the GCC, the private equity industry at US \$15-18 billion is almost as large as the equity mutual funds market - it may even be much bigger if we add investment

management entities that are not incorporated as typical private equity funds but follow a similar model. Over 70 private equity funds were set up since 2002. The size (and number of players) of the industry is just one measure of the contribution of how the private equity industry has changed the regional asset management landscape.

Another measure is its investment coverage, both in terms of territories and sectors. Unlike the mutual funds industry where there is a higher degree of home bias, the PE industry in the GCC has invested throughout the region; its investment territories include GCC,

the wider MENA, Turkey and even South Asia. In fact, MENASAT (Middle East North Africa and South Asia and Turkey) became the hinterland for some PE funds in the region. In effect, the PE industry has a broader reach in terms of sectors, geography and nature of underlying investments. Consequently, the industry is purported to have a much bigger economic significance.

The private equity industry in the GCC region has also grown in sophistication in terms of sectors, spectrum of risk assets and quality of investment professionals. The industry covers a wide range of economic sectors (Figure 21) and has an investment track record in a broad spectrum of risk assets



PE Group	Example Acquisition	Sector
Abraaj Capital	Global Education Management Systems	Education
Emerging Market Partners	AES Oasis	Power
Gulf Capital	Maritime Industrial Services	Energy
Carlyle MENA	Medical Park Sağlik Hizmetleri	Healthcare
Amwal Al Khaleej	Damas	Jewellery Retail
Investcorp	Gulf Cryo	Industrial Manufacturin
HSBC Private Equity	Havelock AVI	Interior Decorations

Source: AME Info, Zawya, Markab Research

including venture capital, SME, infrastructure, expansion capital, buyouts and pre-IPOs. The sector has attracted top tier investment professionals and major institutions from international markets into the region; and it has increased the region's reach into geographies like

Turkey, North Africa, and Asia. The private equity sector has also given entrepreneurs and successful business builders an avenue for seeking expansion capital as well as monetizing their locked wealth.

The private equity asset class has also provided an attractive option to

some of the region's leading institutions to invest in an alternative investment option. It has essentially become a new asset class, with assets under management of US\$ 15.4 billion, (Figure 22) for regional as well as international investors.



Abraaj and HPEME were the pioneers of the buyout funds in the GCC; EMP established the first billion dollar PE fund in the region

ii. Development of the GCCPrivate Equity Sector

The evolution of the PE industry in the region can be divided into five distinct stages:

• Birth of PE - Small to Midsized PE Funds, Very Few Players (Early 2000s): The era of PE funds in the GCC region began in the early 2000s, when management teams of what are now Abraaj Capital and HSBC Private Equity Middle East ("HPEME") pioneered this industry in the region by establishing US\$ 100 -US\$ 120 million funds and established the template for what became known as the 2/20 industry in the GCC region. While Abraaj and HPEME were establishing buy-out funds, Emerging Market Partnership, a global PE firm specializing in infrastructure investments, established a US\$ 1 billion infrastructure fund sponsored by Islamic Development Bank and a

number of sovereign entities from the Islamic world.

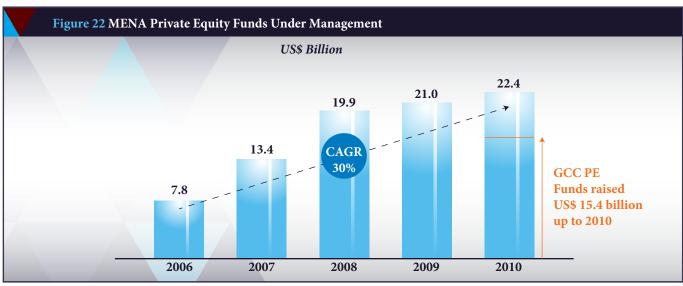
The era of "blind pool" funds, actively

managed by a qualified investment team had already started during the early 2000s when certain venture capital and early stage investment funds (broadly clubbed together as VC funds) were established in the region, making investments in technology start-ups across the GCC and MENA region. During the days of global dotcom era, a number of technology start-ups were also dotted around the Middle East. Subsequent to bursting of the dotcom bubble and when technology start-ups in the region were no more considered attractive by the investors, the blind pool focus shifted to majority ownership in late stage midcap operating companies.

• Explosive Growth - Pro-General Partner Large Size Funds (2004-2007): The PE industry registered its first notable success when Aramex (Text Box below),

now a leading logistics company in the region, got listed at the Dubai Financial Market. It was the first truly PE backed IPO. With the successful exit of Aramex, the PE model was able to demonstrate viability for investors. This era signifies proliferation of new PE funds across the region:

- ► Higher Denomination
 Successor Funds: The pioneers
 (including Abraaj and
 HPEME), backed by the
 successes of previous funds,
 were able to raise successor
 funds of higher denominations
 (Abraaj's second buyout fund
 was for US\$ 500 million);
- ▶ First Time Funds: A number of new first time funds and asset management companies (focusing on private equity) emerged. The size of these funds and number of investors varied widely. For example, Gulf Capital raised its first fund through a large number of investors. At the other end of the spectrum were funds (mostly Saudi Arabia based) with four or five large family groups as investors. Ithmar Capital, a UAE based GCC fund brought 3i (one of the largest global private equity



Aramex Acquisition and Successful Exit by Abraaj Capital

Aramex is a leading global provider of logistics and transportation solutions, which was set up in 1982 in Jordan as an express operator. Abraaj Capital, through its Ist Buyout Fund acquired Aramex in 2002 in a transaction worth US\$ 66 million. The exit was made through an IPO on Dubai Financial Market in 2005. The transaction made 3x returns for the fund, and the capital of the fund was effectively returned from the successful exit of Aramex. The fund had made a number of other investments which were exited separately.

The deal between Abraaj and Aramex entailed all the features of what a successful private equity transaction typically entails. The company had a strong operating track record, which involved its evolution from a local to a regional and international operation. The company had an entrepreneurial CEO and the potential to grow further in terms of providing a wider range of logistics solutions in existing and new markets. The transaction involved an aspect of leverage, and Abraaj Capital managed an exit through an IPO.

Aramex, today, employs almost 9,000 people in 310 locations globally and has a strong alliance network enabling it to provide logistics and transport solutions all over the world. The company has continued to grow since Abraaj Capital's exit, and it can be said that it was private equity money that led Aramex into its next phase of growth and development.

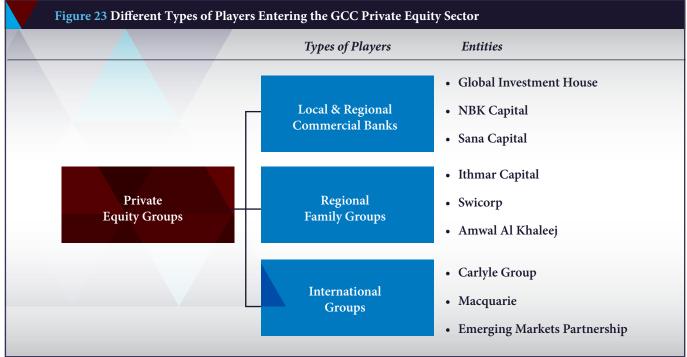
groups) as a partner. These new teams had varying degrees of prior investment experience, with no or limited experience of working together as teams and in most cases the investment experience revolved around a few key persons within the

investment team;

► Institutional Platforms
Including SWF Backed PE
Funds: SWFs and investment
banks also carved out their own
private equity arms. Examples
include Istithmaar (Dubai
based SWF), Global Investment

Source: Abraaj Capital, Aramex, Markab Research

House (Kuwait), The National Investor (Abu Dhabi), NBD (National Bank of Dubai)
SanaFund etc (Figure 23). A number of high profile investments (some highly leveraged) were made via these platforms.



Source: Markab Research

► Arrival of International PE Fund Managers: The growth momentum of the PE industry attracted international PE fund managers to the region. Carlyle and Macquarie established their offices and MENA based funds focusing on investments in the GCC and adjoining regions. KKR, one of the largest buyout fund managers set up its offices in the region – it is not clear if KKR has made any investments in the region.

replaced with competing in auction and geographic boundaries for investments were stretched, to name a few.

Though growing rapidly, the PE industry was developing serious fault lines which included the following:

► Asset Overpricing: There was a rush to make investments. Because assets were rapidly becoming expensive, PE firms sought to make quick

> investments so as not to miss train'. By mandate, PE investment

managers,

the 'investment

generally, have to deploy their investments within three or four years of initial commitment. There was a rush not to exceed this commitment period;

- ► *Leverage*: Liquidity, through easy borrowing, was increasingly becoming available for PE investments. The leverage further contributed to asset overpricing;
- ► *Short-term Flips*: Private equity firms typically acquire companies and hold them for three to five years. During this period, they seek to generate returns through financial engineering, improvement in operating performance and other value levers. Instead of following their classical roles, many firms were simply 'flipping' assets i.e. buying a business, riding on the asset value curve and selling it within a year or so;
- ► Weak Corporate Governance: There was an overall reduction

in accountability to investors, investment reporting was weak and adherence to investment mandate was opaque. Since short-term profits were also being made through 'asset flips', investors were also not pushing for so much accountability.

It is important to note that not all PE managers were susceptible to the above fault lines. Established PE fund managers maintained a balance in their relationship with their investors and instituted a higher degree of governance and reporting standards. Their overall diligence standards and adherence to investment discipline was distinctive. These managers have emerged the strongest following the crash.

- The Crash of 2008 & Lull in Fund Raising & PE Activity (2008): The crash of 2007may have hit the GCC region with a lag of a few months; however, the crisis exposed the fault lines of the PE industry. A major shake-up followed, and some of the immediate outcomes were:
 - ► Fundraising for blind pools became extremely challenging. There was an immediate pause in the fundraising process;
 - ▶ A number of PE funds were either closed down or scaled down owing to investors' liquidity issues;
 - ► The transaction flows were adversely affected. Investment managers started turning their attention to their portfolio companies; many needed additional funding to sustain themselves;
 - ► There was significant asset price deflation. Portfolio monitoring became the dominant activity of the funds

By 2007, the GCC PE industry had its own asset bubble; by 2010, the industry had gone through a major shakeout

Emerging Markets Partnership, a global infrastructure fund manager was among the first international funds to be established in the region. Managing over \$1 billion in assets, EMP's Islamic Development Bank Infrastructure Fund ("IDBIF") had an impressive list of multilateral investors and SWFs, including Islamic Development Bank (the main sponsor), Government of Saudi Arabia (through its Pension Agency), Government of Bahrain, and Government of Brunei.

• The PE Asset Bubble (2007): By 2007, the private equity industry was having its own asset bubble. The region had too many players chasing 'too few deals'. Many investment managers started 'stretching' their investment mandates. Majority interest gave way to passive minority, medium term holding period was replaced by short-term asset flips, quietly negotiated acquisition was

- in the wake of pause in transaction activity;
- Exits through IPOs virtually stopped. The days of "flipping" were over.
- The Rise of The Phoenix: The shakeout closed many firms. Investment professionals, who had arrived late in the boom, quietly disappeared following the crash. Yet, there are signs that a renewed and more mature PE industry is emerging.

Abraaj, the largestprivate equity fund in the region, has announced that it is acquiring Aureos Capital, the world's largest global fund dedicated to the SME sector.

Before that, it established an SME fund. Gulf Capital raised a second fund, which included international investors. Other firms have their own individual success stories.

Generally, the new emerging landscape has the following features:

▶ Deal Specific Models: It is a misnomer that there was a lull in deal flow post financial crisis. The 2008 crash did not prevent certain fund managers from creating a deal flow for their investors. Severe asset price deflation, combined with liquidity crunch created a number of investment opportunities in the region. The well connected fund managers were able to leverage on their investment and investment banking experience to execute these transactions. Whereas the transactions were not undertaken through "blind pools", rather executed on a deal-by deal basis with fund managers economics very similar to that of a fund. This became a very interesting variation of the conventional

PE model where not only investors had more control on the investment decision making, but also were closer to the actual investment.

► Re-emergence of PE Funds:

There are very strong indications of renewed activity in the PE fund space. The GCC region is expected to register far higher economic growth than global average. Asia is now becoming the new hub of economic growth with India, China and some of the other Southeast Asian economies in tow.

GCC has been experiencing high levels of economic growth due to sustained high level of hydrocarbon

prices. Investors,
particularly from Asia are
looking for new investment
propositions and searching for
growth assets in the GCC
region. Established PE players
with a track record of
successfully managing their
previous PE funds stand a
better chance to secure such
investors. A detailed discussion
on future landscape of the
GCC's PE industry is given in
Chapter 4.

The PE industry is now leaner and has shown resilience. The jury may still be out on extent of success or failures of some of the established players. However, indication of new PE funds being planned is a very strong sign of resurgence of the industry. Barring any tail event, PE stands to become a dominant contributor to the growth of the

asset management industry in the GCC region over the next 4-5 years.

Private equity has seen the most interesting and dynamic evolution and despite a major shakeup of the industry during the 2008 crisis; the industry is leaner, stronger and ready for the next round.

B. Overview of the GCC SME and Venture Capital Industry

i. Emergence of the SME Sector

 On 8th-9th November 2010, Abraaj Capital, organized a "Celebration of Entrepreneurship" conference. The conference was attended by a large number of

There are signs that a renewed and more mature PE industry is emerging in the GCC

participants, and the setting was not that of a traditional conference. It was one of the largest conferences for entrepreneurship in the Middle East.

• On 20th February 2012, Abraaj Capital announced its acquisition of Aureos Capital, a global private equity fund specializing in investments in small and medium enterprises (SME) across Asia, Africa, and Latin America.

The two events, the entrepreneurship conference and the acquisition of Aureos, do not represent stand-alone initiatives, but a fundamental shift in the perception of the SME sector in the eyes of the investment management industry.

Prior to entering the market for investments in the SME sector, Abraaj was known primarily as a buy-out and growth capital firm. Abraaj is not only the largest private equity group in the region, its portfolio companies like Arab International Logistics (Aramex), Arabtec, Network International, and GEMS, are some of the largest regional companies in their respective sectors. Despite this, Abraaj has started looking at the SME sector as a key component of its future growth strategy.

ii. Beginnings with Venture Capital²³

The regional investment / asset management industry's interest in start-up and early stage companies dates back to the late 1990s – 2000, the tail end of the internet boom. Funds such as Rasmala's first fund, Injazat, and the Jordan Fund were established with the purpose of investing in the IT and TMT sectors in the region. Dubai Ideas Oasis was established to incubate innovation driven businesses, while even some of the real estate play in Dubai, such as the Dubai Internet City had a technology angle to it.

As a result of all these initiatives in the late 1990s and early 2000s, it was widely expected that a new technology cluster in the GCC was in the making. However, the venture capital industry failed to take off in the region, and in the last 12 years it has managed to raise

"80% of the people in this region that are employed, are employed by SMEs, yet only 26-28% of our GDP collectively from this region comes from SMEs. That gap is humungous. Imagine if that gap came towards 50%, this region would be in a period of sustainable economic boom and growth that no force could turn around or stop."²²

- Arif Naqvi, founder and Group CEO of Abraaj Capital

only US\$ 1.0 billion²⁴.

Even though typically venture capital funds are smaller in size than private equity funds, the overall size of venture capital funds in the Middle East is significantly small. Moreover, majority of the venture capital funds that have been deployed in the Middle East over the last five years have been in investments in the Levant and North African regions, with deployment in the GCC region being negligible.

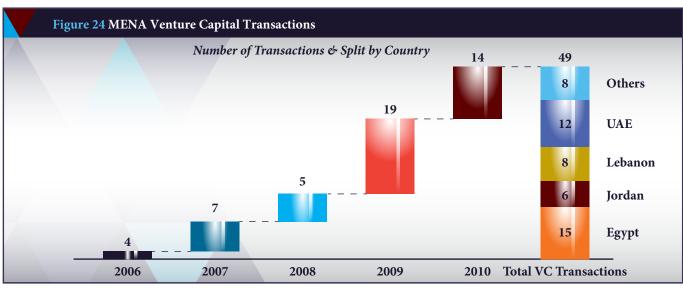
iii. SME Funds – Another Fad or a Long Term Shift?

While the years 2000-02 marked the emergence of the venture capital industry, the years 2010-12 seem to be marking the emergence of an asset management play focused on the SME sector. Though both the venture capital and SME industries seem similar in terms of size of the

investment, stage of investment, and risk profile, the two industries are driven by very different set of factors.

While the venture capital industry is driven by intellectual property and innovation, SMEs are dependent on people, i.e. the entrepreneurs. SMEs are small operating businesses that are cashflow positive at the time of investment, while venture capital investments are typically in early stage firms that have not turned cashflow positive at the time of investment. In the GCC region, laws and regulations regarding intellectual property have not been developed at similar sophistication levels as they are in international markets; therefore it makes venture capital a more risky proposition as compared to SME investments.

Additionally, the investment managers in the region are



Initiative	Sponsor	Est	Mandate
Riyada Enterprise Development	Abraaj Capital	2009	Independent platform dedicated to investing in the small and medium enterprise segment across the MENASA region
Dubai SME	Department of Economic Development	2009	To develop the small and medium enterprise (SME) sector
Khalifa Fund for Enterprise Development	Abu Dhabi Government	2007	To create a new generation of Emirati entrepreneurs, to instil culture of investment amongst young people, and to support and develop small to medium-sized enterprises in the Emirate
Mohammad bin Rashid Establishment for SME Development	Department of Economic Development	2002	To foster the development of entrepreneurialism, encourage and support UAE nationals to actively participate in the economic growth of Dubai, and facilitate the establishment of small & medium enterprises
Enterprise Qatar	Qatar Government	2009	To support and develop the SME sector in Qatar, and become a leading voice and pillar fo SMEs in Qatar

Source: Markab Research

equipped with relatively better skills to evaluate investments in the SME sector, rather than starts-ups or early stage investments. Majority of the SME businesses operate in the sectors, which regional investment managers are familiar with and have exposure in. Investment managers can leverage on their experience curve in the region in assessing SME sector investments, which makes this space more attractive over venture capital investments. For example, understanding the potential of a SME operating in the healthcare or education sector is a lot easier for regional investment managers than assessing the potential of a software or technology provider for the healthcare or education sector.

The SME sector is also more attractive for investment managers, as compared to venture capital, because Government and multilateral agencies participation in the SME sector provides investment managers with a broader pool of funds. The SME sector is also an integral part of the

GCC's social and economic development (Figure 25A). It is the largest employer in the region accounting for 80% of the GCC's labour force, while at the same time it is largely underserved in terms of provision of growth capital that can provide the impetus that SMEs require for contributing to the region's economic development in a larger way.

iv. Challenges to Growth of SME Private Equity

Though the SME industry in the region represents significant potential for growth and vast opportunities for investment managers, there are a few challenges that will have to be overcome in order for this growth to be realized Figure 25B). These include:

Operating Costs:

Investment funds focused on SME investments face a high operating cost structure associated with managing SMEs. Deploying a US\$ 200 million fund over 20 investments is more expensive for fund managers than deploying the same over five large investments, as investment activities related to due diligence and monitoring are more cumbersome for SMEs than for larger organizations.

► Governance Issues:

Introducing governance for SMEs is a lot more challenging than doing it for mid to large corporates. The entrepreneur, who is generally the single most important reason for investment in a particular SME, is the largest hurdle in

SMEs represent the next big frontier for private equity provided that PE funds are able to address operational and cost challenges establishing corporate governance. Investment managers in the region face this challenge of bringing in strong corporate governance structures to the SME sector.

▶ Exit Limitations: Finally, exit potential of SMEs is largely untested in this region, where exit sources are already limited. How investment managers exit from their SME investments will be a key determining factor in the overall growth and development of the SME investments sector in the region going forward.

These challenges will have to be addressed by investment managers in the GCC SME sector. The two key factors are costs and corporate governance, and several investment managers are already considering increasing their focus on investment process streamlining, standardization, discipline, and outsourcing in order to address these two factors. This highlights a shift in the mind set within the investment management industry, which already has the investment capability required for making SME investments, however needs to develop operating capabilities to realize the full growth potential of this industry in the GCC.

C. Overview of the Islamic Investments Industry

i. Explosive Growth of Shariah Compliant Products

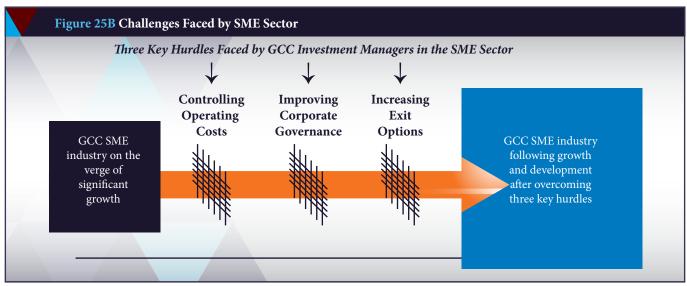
Over the last 10 years the investment management industry has seen an explosion in the growth of Shariah compliant products. This growth has taken place across asset classes including mutual funds, private equity, and debt instruments (sukuks). Even international investment and wealth management products marketed by regional banks are increasingly coming packaged with an Islamic wrapper.

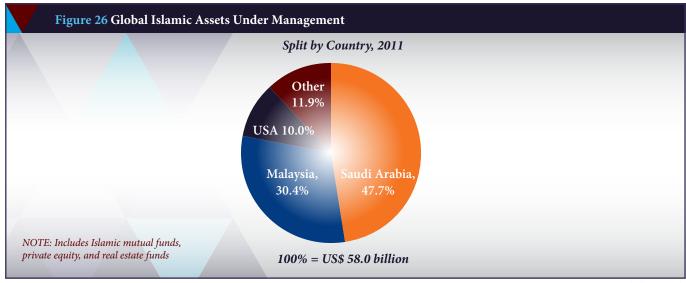
Shariah compliant products are expected to continue their upward growth trajectory over the next few years. In 2007, Shariah compliant funds accounted for 50% of GCC mutual funds' assets under management; their share in 2011 had increased to 61% amounting to a total of US\$ 22.5 billion²⁵. With the share of Shariah compliant funds expected to continue its upward momentum within the GCC mutual funds industry, it is expected that Islamic funds will account for approximately 70% of assets under management by the end of 2015. For every additional dollar of asset under management in the GCC region, 60-65 cents is expected to be in a Shariah compliant product going forward.

ii. Demand Drivers of Shariah Compliant Funds in the GCC Region

The GCC region, led by Saudi Arabia is the global hub for Shariah compliant products. The region is the centre for demand and supply of Islamic funds accounting for 52% of the global Islamic assets under management²⁶. Saudi Arabia is the leading market for Islamic funds with funds marketed by fund managers in Saudi Arabia accounting for 48% of the global Islamic assets under management. The growth of Shariah compliant products in the GCC region has largely been driven by demand from investors who have increasingly demanded Islamic investments over the last decade.

The investment management industry in the GCC has developed the skills and capabilities to develop Shariah compliant products that deliver the same kind of returns as conventional products. Since investment managers are able to provide Islamic products without compromising on the risk-return profile, the investors are not faced with a trade-off between Islamic and conventional products. This historical latent demand for Shariah products has in recent years become more active and is driving the growth of the Islamic funds industry in the GCC.





The market for Islamic funds needs to be at par with the market for conventional products very rapidly due to the nature of Shariah compliant products. Investment managers have created mirror products where it has been possible, e.g. mutual funds and bonds, while where that has not been possible, the industry has established Islamic wrappers. Investors are now presented with a large variety of Shariah compliant products enabling them to increase their allocations towards diversified Islamic products.

Even though Saudi Arabia is the global centre dominating the Islamic funds industry, there are other global centres that have emerged on the back of increasing demand for Shariah compliant products. Malaysia, Luxembourg, and Ireland are examples of markets that have emerged recently where Islamic products are increasingly being developed. The demand for Islamic products has been so compelling in the last few years that leading international players from the US and UK have also entered this space, and there has been an increase in the number of pure play Shariah compliant investment managers who are specializing in creating asset management plays around Shariah compliant products.

This growth in the number of providers of Islamic funds, increased diversity of Shariah compliant products, emergence of pure play Islamic asset managers, in addition to investment managers voluntarily opting to provide investment opportunities under Shariah compliant structures have all collectively added to the significant growth of Islamic assets under management in the last few years.

iii. The Next Phase ofDevelopment in the IslamicInvestments Industry

The building blocks for further growth in the regional Islamic investments industry are already in place. The region is already a hub for Islamic funds with a dominant share in the global Islamic funds market; however it has the potential to become a centre for a regional and international Shariah compliant asset management play. With international players increasingly offering Shariah compliant products, and also leading in innovation efforts, the GCC region has the potential to provide international players with a platform to develop and market their Shariah compliant products. This region can cater to the Shariah requirements of global investors, as well as, provide world-class Islamic

Source: E&Y, Markab Research products to regional investors. The next phase of growth in this region's Islamic investments industry will come from attracting assets into Shariah compliant products from all over the world in addition to providing a base to asset managers for developing and marketing global Islamic products.

The asset management industry in the GCC has become more diversified in the last decade. The mutual funds sector has experienced a conventional growth path, pairing itself with the growth in the capital markets. The private equity industry, on the other hand, has emerged as an asset class with substantial economic significance. The role of the PE²⁷ industry will remain central in the growth of the GCC's asset management industry over the 4-5 years. Apart from mutual funds and private equity, there are other asset classes which are in very early stages of development. This includes fledgling fixed income funds market and real estate funds. Both of these asset classes are struggling due to various structural and market related factors. Venture Capital and SME, though broadly included in the PE domain, have shown promise. However, challenges remain in the way of future growth of these asset classes.

V

Chapter 3 Key Investor Groups and their Emerging Role

GCC is home to some of the most influential investor groups globally. Sovereign Wealth Funds ("SWFs") from the region are counted among the select sophisticated global investors who hold significant stakes in large global corporates, international banks and financial institutions, and landmark real estate across the world. The region's HNWIs, including principals of premier family groups and well-known financial investors, have established track record of making diversified investments around the globe; either directly or through their regional and global asset managers. This chapter covers four key investor groups in the region (including SWFs and HNWIs) covering their current state

(particularly after the global financial crisis) and their emerging role going forward. The discussion is framed in the context of each group's structure, investment scope and objectives, and operational capabilities. In the next phase of growth in the region's asset management industry, the attributes of these investor groups and their potential role in shaping the investment landscape, will have a direct bearing on the future evolution of the industry.

A. Overview of the Major Investor Groups

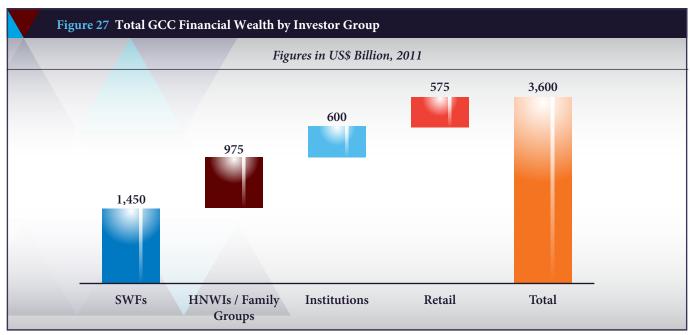
i. GCC Region's Wealth

An aerial view of the GCC wealth

profile, whether now or ten years ago, gives us a fairly unchanged picture. It is a picture of a vast amount of wealth (trillions of dollars), of which only a small percentage (less than 10%) is invested in the region.

As of now the GCC region is estimated to have approximately US\$ 3.6 trillion (Figure 27) in financial assets, mostly invested abroad, or held with individuals as cash or bank deposits. This wealth in the GCC is held by four major investor groups comprising of SWFs, Family Groups & high net worth individuals (HNWIs), institutions, and retail customers.



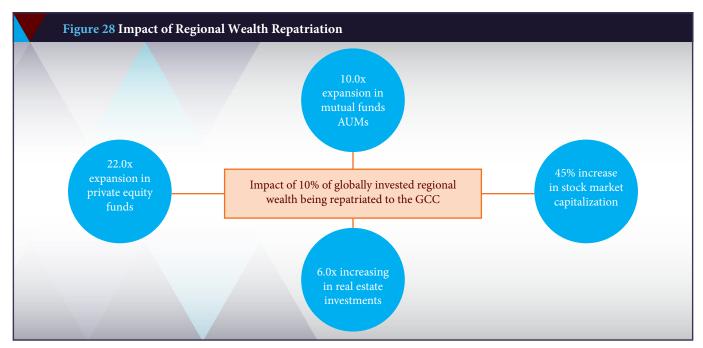


Source: Markaz Sector Report, Global Investment House, Zawya, Mind Power Solutions, Markab Research & Analysis NOTE: Institutions include commercial banks, central banks, Government, pension funds, insurance funds, and non-financial corporations

Ten years ago, even though both the overall regional wealth and the size of the asset management industry in the region were much smaller, the

percentage of total wealth invested in the region was about the same. An aerial view of the regional asset management landscape would be simplistic and possibly misleading. The region already has tremendous wealth and (barring tail risks such as collapse in oil prices) is expected





Source: Markab Analysis

to generate higher amounts of wealth. Even at current levels, repatriation of small amounts of asset management industry. For example, if about 10% of the

equity, and real estate. The model for sustainable growth of the asset management industry is not a function of the region's investible wealth; rather it is a function of the industry's ability to build depth and

capacity.

Each investor group is driven by its own set of dynamics and impacts the asset management industry in a

distinctive manner. To understand the role that each of these groups can play in shaping the industry, it is necessary to move away from the investible wealth bias and assess investors groups and their role going forward by taking a closer view of their operative models. It will be important to understand how these groups are organizationally and culturally structured, what is their investment approach, what capabilities have they built and how did the financial crisis impact them? Some key areas that require a closer assessment

• Overall structure;

include the following:

wealth can dramatically impact the

Investor groups need to be addressed on the basis of their operating model rather than the amount of their investible wealth

regional wealth invested abroad is repatriated and reinvested into the regional stock markets, market capitalization of regionally listed companies will go up by 45%, (Figure 28) which will, in the absence of new issues, create a stock market bubble.

ii. A Closer Perspective - Moving Away From The Investible Wealth **Paradigm**

A rapid repatriation of regional wealth invested abroad carries the risk of asset or stock price bubbles. In the past ten years, regional investors have gone through bubbles in public equities, private

- Investment approach and models for asset allocation;
- Factors shaping the groups in the past ten years;
- Investment organization;
- Impact of the financial crisis;
- · Possible role going forward

B. Sovereign Wealth Funds (SWFs) – The Largest **Investor Group**

i. SWFs Invest Internationally

Oil wealth can largely be attributed to good geography. Effective deployment of this wealth comes from a sound vision and good strategy. The GCC countries have been deploying their surplus wealth in a global pool of assets and securities through their SWFs. Most of this wealth, approximately 90%28, is invested in international assets and securities including equities, private equity funds, hedge funds, and corporates. Regional SWFs have been prudently investing their surplus wealth for over 30 years. By following this investment approach the SWFs, including ADIA have created an effective hedge against a collapse in oil prices.

SWF	Country	Established	AUMs (US\$ Bn) 2011	AUMs Spli	t by SWF 2011
ADIA	UAE	1976	627.0	US\$ 1,458	3.9 Billion Other Holdings
SAMA FH	Saudi Arabia	2008	439.1	5.8%	QIA
KIA	Kuwait	1953	202.8	13.9%	KIA
QIA	Qatar	2005	85.0		
IPIC	UAE	1984	48.2	20.10/	04354
ICD	UAE	2006	19.6	30.1%	SAMA
MDC	UAE	2002	13.3		
MHC	Bahrain	2006	9.1		
SGRF	Oman	1980	8.2		
PIF	Saudi Arabia	1971	5.3	43.0%	ADIA
IDO	UAE	2004	1.2		

Source: Zawya, SWF Websites, Markab Research

ADIA: Abu Dhabi Investment Authority, SAMA FH: Saudi Arabia Monetary Agency Foreign Holdings, KIA: Kuwait Investment Authority, QIA: Qatar Investment Authority, IPIC: International Petroleum Investment Co., ICD: Investment Corporation of Dubai, MDC: Mubadala Development Co., MHC: Mumtalakat Holding Co., SGRF: State General Reserve Fund, PIF: Public Investment Fund, IDO: Investment & Development Office

ii. Direct Investments & SWF Activism

In the past ten years or so, SWFs have become more active in making direct, high value and high profile investments (Figure 30).

Transactions have included global banks, hotels, automobile companies, entertainment companies etc. Some transactions such as the acquisition of Peninsular and Oriental Steam Navigation

Company (P&O) by Dubai Ports

World even courted political reaction.

Direct investments are distinct from the traditional investments that SWFs typically make through global fund managers, or in the US and other government securities. In the case of the latter, the SWFs' main role is in allocating portfolio and selecting fund / investment managers. Most of the leading global investment banks, asset managers, hedge funds and private

equity funds seek investments from one or more SWFs in the GCC.

Direct investments require establishing a world class investment team internally. These operate organizationally and operationally like other global teams of sophisticated investment managers, experienced in making direct investments. SWFs have, in the past few years, built their own world class investment teams, which have led sophisticated global investments.

Figure 30 GCC SWFs Transactions			
SWF	Transaction	Territory	
Abu Dhabi Investment Authority	Citigroup	North America	
Abu Dhabi Investment Authority	Hyatt Hotels	North America	
Abu Dhabi Investment Authority	Solveig Gas	Norway	
Mubadala Development Company	Pearl Energy	Southeast Asia	
Mubadala Development Company	Ferrari	Italy	
Qatar Investment Authority	Harrods	UK	
Qatar Investment Authority	Miramax Films	North America	
Qatar Investment Authority	Paris Saint-Germain	France	
Qatar Investment Authority	Credit Suisse	UK	
Kuwait Investment Authority	Daimler AG	Germany	
Kuwait Investment Authority	Citigroup	North America	

Source: Markab Research

SWFs making direct investments continue to grow in sophistication. To address concerns about possible political objectives, SWFs have increased their level of disclosure, e.g. ADIA, for the first time in its 36 year history, has released some details of its investments. Some regional SWFs are among the 27 signatories to the Santiago Protocol, which requires SWFs to provide more information about their investments.

acquired equity interest are also setting up joint ventures in Abu Dhabi.

iii. The Role of SWFs Going **Forward**

SWFs will continue to remain globally focused, and their direct role in developing the regional asset management industry will probably remain limited. Direct investments by SWFs have helped them build in-house capabilities that can have a

> regional context, such as a role in establishing public sector led Infrastructure Funds in the region and in setting up

investment teams. They could provide a consultative role in setting up good quality investment teams and world class investment process for government led infrastructure funds. On a case to case basis they could also establish regional joint

ventures with their investment companies, which could over time be listed in regional stock markets.

C. HNWIs & Family Groups - The Largest Participants

GCC HNWIs and family groups are the largest and most significant participants of the regional asset management industry across all asset classes. Even though they vary widely in size and investment allocation, there are features common to most HNWIs and family groups.

i. Operating Model

Most family groups have one or more well established operating businesses in their home country, which generate surplus cash for regional and international investments. The larger family offices have in-house dedicated investment teams (Figure 31); the investment teams are typically small, and investment decisions are led by family heads. Whereas, the smaller and mid-sized family

HNWIs and family groups are among the largest investors across all asset classes of the regional asset management industry

Following the financial crisis, SWFs from the region seem to have become more active in making direct investments. Some direct investments are being made with a regional perspective. Some of the companies in which Mubadala has

Figure 31 Typical Structure of a Family Office **Family Office** Chief Investment Officer **Operating Asset** Cash + Investment Team of 3-5 investment professionals **Local Equities Real Estate** International Direct Invest-Support & Investments ments & Funds Monitoring • Equities • In regional Across the GCC GCC stock Operating assets Mutual funds companies across markets · Private equity business sectors · Regional mutual funds funds · Hedge funds · Regional private equity funds

groups mostly work through other asset managers or make direct investments opportunistically.

ii. Investment Approach

HNWIs and family groups have divided their investments into regional and international investments; however, most of them quickly recalibrate their portfolio between regional and international investments, and between asset classes, depending on where they see maximum returns. Investments are allocated across the GCC, Levant, South Asia, and North Africa, and across mutual funds, private equity funds, real estate, and equities (Figure 31). HNWIs and family groups have also shown the propensity to shift investments to assets generating higher returns and riding asset boom curves. For example, they were the largest investors during the regional real estate, technology, and stock market booms.

iii. Shortcomings of the Family Office Structure

The global financial crisis demonstrated that such an operating model and investment approach were not configured for optimal asset allocations, and several shortcomings of the model were exposed in the aftermath of the crisis.

One of shortcomings of this model was that family offices did not build any dedicated expertise for a specific area within their investment team consistent with their large portfolio of diversified assets. Investment managers at family offices focused on making investments across sectors, and therefore did not develop core sector focused expertise. Additionally, some degree of owner bias exists among family offices, and very often, investments are influenced by heads of family groups, which means that they may not necessarily fit the investment guidelines or criteria that has been

developed by the investment team.With family offices undertaking a large number of diversified investments,

monitoring becomes a big challenge as there are small teams managing a large and diversified portfolio. HNWIs and family groups also faced challenges related to liquidity due to the global financial crisis and following the collapse of regional stock markets

iv. Role Going Forward

Despite these issues and challenges, HNWIs and family groups can continue to play a strong role in the regional asset management industry. They can continue to be the largest participating investors across regional asset classes, however a few key steps are required to ensure their continued success in the region, including:

- **1.***Portfolio Mix:* It has been three years since the financial crisis and a new economic cycle has started. Therefore family offices should take note of the fact that asset prices have deflated since then, and that many of their investments were misjudged. They need to look to carve out their bad assets and develop a defined strategy for restructuring their portfolio. They would require a separate team (independent of the investment team at family offices) to monitor their existing portfolio and decide on the optimal mix of assets by carving out the loss making ones.
- 2. Defining Investment Criteria:
 Historically asset allocations of family groups were modified to ride the different growth waves, such as those of capital markets, real estate, etc. Family groups could look to redefine their overall

Family Groups' primary focus should be portfolio diversification and selection of fund managers

> investment strategy by developing investment criteria, which will cover asset classes, geographic mix, and sector diversification.

3. Fund Manager Selection: Family groups cannot develop expertise in all sectors and geographies that they invest in; therefore they could look to limit their role to selecting the right investment managers. Rather than making investments directly, family groups should look to select the best investment for their various asset allocations. In some cases, they may even seed fund management companies but the role of the family office should be that of selection and monitoring of investment managers.

In order to sustain their investment activities over the longer term however, family offices should look to replicate structures of other international family offices, whose primary role is asset allocation, fund manager selection, and where required, board level activism.

D. Institutional Investors – An Important Part of the Regional Asset Management Industry

i. Regional Institutional Investors

Institutions in the GCC region comprise of central banks, commercial banks, pension funds, insurance companies, and other non-financial corporates. They have surplus wealth, which was largely unaffected by the financial crisis, and they are the key source of funds for regional private equity funds.

They are also large participators in regional stock markets. They typically have in place a well-defined investment criteria and a monitoring mechanism.

Regional institutions do not have a substantial role in building market depth, however once market depth increases in the region through more listings, etc. they have the potential to participate increasingly and increase their investments. They are a key component of the asset management industry, and will continue to be the key providers of capital for the regional private equity industry.

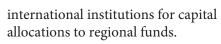
ii. International Institutional Investors

Similarly, there are large international institutional investors that have a global portfolio allocation; however, most of these investors are under weighted in their allocation to the GCC. There are several reasons for this. The GCC has historically been seen as a small and overvalued market for public equities. Private equity funds mostly raise money from regional institutional investors and family groups. Moreover, overall information about the GCC investment opportunity is relatively poor in international markets. International institutions also became more cautious about the region following the restructuring of Dubai World, which has resulted in smaller allocations from them in the GCC.

Going forward, international institutions represent a key opportunity. The restructuring of Dubai World and Dubai Holding, in comparison to what has happened in Greece, and the possible contagion effect across Europe, was very benign. The crisis in Europe resulted in Asian investors, from countries like China and other emerging markets, looking at other global markets for investments. Since these investors are from emerging markets themselves, they are able to understand and manage other emerging market risks better.

Regional fund managers, like Gulf Capital, have demonstrated the ability to raise international commitments. Based on their initial success, private equity managers in the GCC can capitalize on this and approach other

International institutional investors may play a leading role in the next phase of development of the GCC's asset management industry



E. Retail Investors

Retail investors are a significant source of investments and liquidity; however they are only relevant to the mutual funds industry. Their participation across other asset classes such as equities and real estate funds will depend on regulations allowing the participation of expatriates, who make up a large part of the retail investor base.

Till the early 2000s, the real estate market in the GCC was not open to investment from expatriates, which was driving real estate investments by expats in their home countries. However, this trend changed in the mid-2000s when starting with





Dubai, many GCC countries opened up their real estate sector to foreign investment. This significantly increased expatriate investment in real estate in the region, however this lasted for a few years till the market crashed in late 2008 resulting in significant losses for expatriates. Since then majority of their wealth has been increasingly directed towards their home markets due to a lack of confidence in the investment environment.

Expatriates also do not have access to majority of the local equities listed in regional stock exchanges, so the only way for them to participate in capital market activity is through mutual funds.

The high income retail groups typically utilize the services of wealth managers and private bankers in the region and generally invest in international equities and local assets such as mutual funds. However, majority of the wealth held by retail customers is in the form of cash, bank deposits, and fixed deposits, which demonstrates the large untapped wealth that can be targeted by the regional asset management industry.

Attitudes and preferences of retail investors have changed significantly since the global financial crisis and they would now rather focus on principal protection or a variation of guaranteed returns, as opposed to asset accumulation.

F. Future Role of Investor Groups

Overall, investor configuration in the regional asset management

industry is changing. International and regional institutional investors will be main sources of capital for private equity funds, while family groups will progressively join as they iron out their legacy issues and rebuild their liquidity.

For mutual funds, retail investors and regional institutions will be the largest participants, while international investors can participate depending on the multiple being generated by the market.

Sovereign Wealth Funds will continue to focus on investments in the international markets. However, their role in providing seed financing and advisory support in setting up regional asset management initiatives cannot be ruled out.

VI

Chapter 4: Opportunities and Challenges for the Asset Management Industry in the GCC Region

A. Overview

The asset management industry in the GCC region, though young and still in early stages of its evolution, possesses tremendous growth potential, given the region's economic profile, business culture and growth possibilities. These overarching advantages, if leveraged properly, can result in catapulting the region's asset management industry to the next stage of its evolutionary growth. The financial crisis of 2008 has provided an opportunity to the region's asset management industry to assess its shortcomings, address key challenges and capitalize on new

emerging opportunities.

The economic and capital allocation imperatives of the region, at least for the next 5-10 years, presents an opportunity for asset managers to play the role of catalysts in business building, creation of employment opportunities and wealth creation for institutions and individual investors alike. This chapter presents an assessment of opportunities and challenges for the industry, specifically in the context of its established and emerging asset classes. The chapter also highlights some of the macro challenges being faced by the GCC region, which will have a direct bearing on the growth

of the GCC's asset management industry.

The last ten years of economic growth and business cycle have set the building blocks to help chart the growth path for the regional asset management industry in the region. The growth of the asset management industry cannot be divorced from the region's economic prospects. Although the region has substantial wealth and available capital it needs to create diversified opportunities for deployment of capital, and an organized group of well-established and credible asset managers who can facilitate capital



allocation and generate significant risk-adjusted returns for investors, in order for the asset management industry to grow.

While, there are overlaps, each asset class is driven by its own set of dynamics, and thus needs to be assessed almost independently. Within the GCC region, asset management can be segregated into two main buckets. One is public securities linked asset management industry (where the underlying assets are listed stocks and bonds) and the other is private equity linked management (including venture capital, buyout and infrastructure funds). As seen in the previous chapters both asset classes have demonstrated different growth trajectory, are at different stages of development and will be influenced by almost different set

of factors going forward. The two asset classes need to be delinked from each other.

The public regional stock markets in their current shape are small, fragmented ad somewhat shallow. These conditions severely limit the stock markets from becoming a key platform for the next level of growth of the asset management industry. Unless depth is built through IPOs and multiple listings, they will present limited scope for asset managers. This is not to take away stock market's role and significance; it is just that it will not be the primary driving force in the medium term growth of the asset management industry.

Stock market depth cannot be built overnight. Even if key steps are taken by policy makers to increase depth and the enabling economic environment remains conducive, it may take two to three years before the public markets reach their point of inflexion, or critical depth from where growth momentum can accelerate rapidly.

Private equity may have more of the key building blocks in place. To start with, the overall universe of investment options is much bigger - a pre-condition for successful asset management, which in essence is a portfolio management business,is its past success, overall learning curve and presence of successful champions are other key drivers of growth. But there are challenges too. The industry has gone through a crisis management mode. Many investments may need to be written off, several asset managers have gone out of business.



Segregating the industry into two asset classes provides a partial view of opportunities and challenges. Each of the two asset class has highly nuanced sub-classes, which may be difficult to club together. Each asset class (and its sub-class) needs to be assessed closely and independently.

i. Defining the Assessment & Ranking Framework

The following criteria may serve as a relevant guide for assessing each asset class (and sub class) and ranking them in order of growth prospects going forward.

1. Convergence with the GCC
Economic Narrative: By and large, the GCC economies have similar economic narratives. The economies are on a path to maintain their momentum of growth, diversify their income away from oil and create employment and entrepreneurial

integration is another key theme for the GCC. The segments of the asset management industry that have the closest convergence with the GCC economic narrative stand to gain the most in terms of growth prospects.

2. Availability of Capital and **Investor Appetite:** The region is a major source of investible wealth. Hydrocarbon exports are expected to continue to generate wealth and possibly more surplus capital. Investor groups, whether SWFs or the private sector (including family groups, HNWIs and even retail investors) are exercising great caution. There is increased level of risk aversion and a severely reduced appetite for leverage. Inany case, banks are also lending more selectively. On the positive side, there is progressive improvement in liquidity, balance

quire (regional family groups in particular) are on the mend and there is portfolio

value reflation, as a result of recovery in global stock prices. Investors will prefer asset classes that have the potential for value enhancement and managed risk.

3. Size and Diversity of the Pool of Opportunities: The above two criteria are relevant for choosing asset classes, but do not necessarily highlight the need for an asset manager. For example, real estate portfolio can be built through direct investment or a star equity stock can be bought directly. Why need an asset manager? The following attributes point to the need for asset

managers. One where there is a large universe of assets to build a portfolio from and a dedicated asset manager can do a better job in portfolio selection. Two where specific skills are required for value creation that the investors may not directly possess. And three, where the size of a single discrete investment (typically infrastructure) that participation requires a pool of investors to come together and entails complex negotiations.

- 4. Availability of Managers and Quality of Track Record: Certain asset classes require more advanced investment management skills than others. Investment managers are expected to deliver 'alpha' on the investments. Alpha is a measure of superior returns on a portfolio, generated through active investment management. Investors would prefer sectors and funds where a pool of good quality investment professionals is available. For example, the GCC does not have many good quality hedge fund professionals. On the other hand it has a strong pool of private equity investment professionals. Individual track record of managers now matters less; investors would look at team track record and whether key managers have worked together.
- 5. Return, Liquidity and Horizon Characteristics of the Underlying Asset Class: The alternative asset classes tend to offer higher risk-adjusted returns. With the growth embedded in the region, both regional and international investors are seeking investment opportunities in the GCC. Private equity investments tend to have lower liquidity and longer holding period.

Successful asset classes will require convergence with the region's economic narrative diversity and strong talent pool

opportunities for their national populations. Owing to similar economic structures, demographic profiles, and challenges faced by the government; a very similar set of economic objectives and priorities have been set by the respective governments in the GCC region. The initial phase of economic growth is public sector led (new infrastructure, new economic clusters etc.). Policy makers are also conscious of private sector participation and the need to build competitive economies. Further regional economic

		Cri	iteria			
→ Low	Convergence of Economic Objectives & Priorities	Availability of Capital & Investors	Size & Diversity of the Pool of Opportunities	Availability of Managers & Quality of Track Record	Return, Liquidity and Horizon Characteristic	Overall Ranking
Asset Classes Private Equity – Expansion & Growth Capital					s	0
SME Funds						
Private Equity Infrastructure						
Equity Mutual Funds						
Fixed Income & Sukuk Funds						
Real Estate Funds						

B. Opportunities & Challenges by Asset Class

Based on the above criteria, the following asset classes are expected to be critical sectors for the growth of GCC's asset management industry (Figure 32) in the medium term.

- i. Private Equity Expansion and Growth Capital
- ii. SME Funds
- iii. Private Equity Infrastructure
- iv. Equity Mutual Funds (primarily Equity Funds)
- v. Fixed Income and Sukuk Funds
- vi. Real Estate Funds / Real Estate Investment Trusts ("**REITs**")

i. Private Equity – Expansion and Growth Capital

Post 2008, the market clearly segregated between pure play private equity funds and first timers. The winners were those who had

fully deployed first funds, raised additional and multiple funds, made successful and profitable exits, and did not face any major challenges with their investment strategies. There were few private equity groups that managed this successfully as the industry went through a major shake up with many players closing down and funds being shelved. Moreover, private equity players also started facing challenges with the management and operations of their portfolio companies.

What was once viewed as an exciting investment opportunity was now viewed with caution by investors. A 'crisis of confidence' had set in post 2008 in the GCC region with private equity groups, focusing on management and balance sheet repair of portfolio companies and investors dealing with investment write-downs.

Due to these factors, the private equity sector in the GCC witnessed

Source: Markab Analysis a shift in business models. Investor activism has led to an increased focus on portfolio management and restructuring, renegotiation of management terms and conducting new transactions outside the blind pools, on a deal by deal basis, rather than under the traditional model of private equity.

Generally, the governments in the GCC countries have economic diversification high on their agenda. During 2005 and 2008, private equity funds in the region emerged as a catalyst to economic growth, supporting expansion of a number of companies. The case of Aramex mentioned in the earlier chapter is a demonstration of how a PE firm can contribute to performance enhancement of a growth-centric company.

The region has a "PE memory". One of the key messages from the legacy of the first crisis in the PE industry is that the industry in general has to develop an industrial approach to

investments rather than relying on financial engineering to generate returns. Investors will judge propositions of future funds and fund managers on the credibility of value creation case.

a. Opportunity Landscape for Private Equity

► Opportunity for Successor
Funds: There have been major
shifts in the competitive
landscape. Track record and
investment team's ability to
work together will matter
mre. Private equity managers

some of the new formats that have already started evolving.

- ► *Small is Beautiful:* First time funds would need to be much smaller with well-defined use of management fees.
- Leading private equity firms have raised investments from institutional investors outside the GCC region. The region's investment narrative is strong. Precedence for international investment has also been established. Private equity firms

with good track record and international standard corporate governance can

First time funds need to be smaller specialized funds and have strong corporate governance

with a successful track record, including exits will draw more attention than first time funds.

► Attractive Valuations:

Valuations have returned to more reasonable levels before the financial crisis. There are bargains to be made. Besides, PE funds that invest at the early stage of the economic cycle have a greater prospect of riding the business cycle. Efficiently run companies growth capital will be in a much stronger competitive position.

► From Blind Pool to
Specialization: Though
investors will hesitate in
creating 'blind pool' funds with
first time investment managers,
they will look at attractive
investment opportunities,
managed by good teams. Sector
specialization, hybrid PE
structures, transaction-by
transaction PE structures are

generate interest from international investors.

▶ Governance is the Key: There will be increased focused on transparency, reporting and corporate governance.

Investment managers that demonstrate commitment to remain tightly focused on investment mandates will garner greater interest. For new funds, investors will seek greater board level activism.

b.Specific Challenges – Private Equity

Despite the above mentioned opportunity areas and improved level of optimism, the GCC's PE industry is facing a number of challenges. These include:

► Challenging Fundraising
Environment and Investor
Fatigue: With investor
fatigue setting in place, the
investors are by and large
averse to blind pool
propositions. For the growth of

the private equity sector going forward, it is imperative to overcome the crisis of confidence that was set in following the financial crisis in 2008. Investors need to recognize that some of the leading global private equity players have also faced crises and had to restructure themselves. Restructuring is a part of the evolutionary process of the industry and should be regarded as lessons that are being learnt globally. Indications of Asian investors' interest in the GCC PE industry is an encouraging sign and can be the beginning of resurgence in fund activity in the region.

- ▶ Portfolio Monitoring and Value Enhancement: A majority of PE fund managers are working vigorously on monitoring of their portfolio investments with an aim to return monies to their investors. This can be a long drawn process considering the valuation differentials and slowdown in IPO activity and caution exercised in trade sales.
- ▶ Pressure on Fees: PE fund managers are facing pressures on their management fees structures globally. The managers must rationalize their cost structures and must not treat their operations as profit centres. However, the fees structures are not expected to change drastically.
- ► Management Team Quality and Adherence to Investment Scope: An overall improvement in regional expertise is also required to overcome the crisis of confidence. Strong management teams with a proven track record, regional

- expertise, and domain knowledge will be key to success.
- **Exits:** A slowdown in the IPO activity has effectively taken away one of the leading exit options for the PE funds. Reliance on trade sale has led to longer holding periods and thus affected overall expected returns on investments. The trade sale market will remain active, throwing up opportunities to exit from well performing portfolio companies. A rebound in the regional capital markets is likely to invigorate IPO pipeline, as are indications subsequent to very strong first quarter performance in 2012.

ii. SME Funds

The SME sector is facing severe problems very similar to that of early stage firms, in terms of access to capital. Banks are typically wary of SME financing and evidently have gaps in their offerings for the SME sector. Equity financing is a more viable financing route, which can be coupled with strategic advice, assistance in growth, improvement of corporate governance and assistance in building joint ventures and partnerships.

Establishment of SME funds offer a real opportunity to address the funding challenges faced by SMEs in the GCC. Despite contributing around 28-30%²⁹ of GDP in the region, 85%³⁰ of the SME funding is generated through internal resources. The banking system, on an overall basis, has not been able to bridge the huge funding gap in this important sector of the economy.

SME funding requires a distinct set of investment discipline, investment horizon and return expectations. For some of the large global funds investing in SMEs is more about social and economic development rather than financial investing.

The key success factor in managing viable SME platforms is to have on the ground local teams working on identifying the appropriate opportunities and managing investments.

a. Opportunity Landscape for SME Funds

With the exception of few SME focused funds, the landscape for these funds is wide open. Following are some of the key opportunity areas:

► Smaller Sized Focused Funds:

There is merit in being focused and having on the ground presence. SME investments require more time and even more personal interaction

with the key persons.

A good variation of such a fund can be

focused on a specific sector, making investments in companies which can have synergies in being together. This not only facilitates configuring the investment team but also enhances the overall value of the portfolio on exit.

► Efficiently Run Platforms:

Operating costs can be a critical factor in running SME funds since quantum of management fees may not be as sizable as that of a PE/buyout fund. Funds running efficient operations through standardization of key functions (deal generation, investment analysis etc.) and outsourcing some of the non-core activities can have a

competitive advantage.

► Clear Focus – Startups are **Different from Midcaps:** Funds operating in this space will need to focus on their space. Startups and early stage companies are very different from profit generating mid-sized companies. Early stage companies require less capital, but very high level of monitoring and operational support. More small companies fail than succeed, but successful companies generate spectacular returns. Midcap companies are closer in structure to traditional buyouts. They require more cash but less operational support. Failure risks are lower, yet returns may not be as high. Whatever is the case, investment firms will need to

Controlling operating costs and generating exit options are key challenges for success of SME funds

have very clear focus.

► Availability of Cheaper Funding Sources: Cheaper funding may be available from government and multilateral organizations. These include long-term low cost loans. To achieve this, SME funds would need to be convergent with social objectives.

b.Specific Challenges - SME Funds

Despite the above mentioned opportunity areas and improved level of optimism, the GCC's SME Funds industry is facing a number of challenges. These include:

► *Inadequate Returns:* This is one of the most quoted challenges related to

investment in SMEs. Although there is no regional track record to support or contradict this argument, investors will expect a return higher than a PE fund on SME transactions. Development institutions can be targeted as potential investors for the fund, who will have a much more conservative expectation of returns. Additionally, the fund manager should conduct a thorough due diligence to determine an entry price such that it facilitates an attractive exit proposition.

► Lack of Corporatization and Governance: This challenge needs to be embraced when taking on SMEs. A growing SME will need assistance in improving corporate governance and the way decisions are taken within the organization. The entity will most likely be dependent on single person, product or market. This is where an SME fund can play a constructive role by combining financing with strategic advice.

absence of a secondary exchange for SMEs, a trade sale market is expected to remain active.

Like the VC industry, SME sector has also been neglected by the asset managers for a host of reasons. Lack of corporate governance, reliance on single person or single product, and perception of high risk and low returns, combined with low prospects of exits kept the PE firms away from this space. Development institutions can be targeted for investment in these funds. Unlike PE, this is an untested area and there is no adverse track record. The industry of SME funds is in early stages of evolution.

iii. Private Equity -Infrastructure:

Infrastructure will represent the most significant area of opportunity for asset managers. The governments in the GCC region have a cumulative budget of over US\$ 1 trillion on infrastructure

projects over the next 10 years.
Development of infrastructure is very high on economic agenda.
Although

governments are expected to provide a majority of capital requirements, significant participation is expected from the private sector both as investors and developers/operators in these projects.

In the more developed economies, infrastructure funds have played a very significant role in delivery financing, particularly equity financing. In the UK, Australia and Canada, there is a diverse presence of different types of infrastructure funds. Macquarie, an Australian

asset management company can be considered a pioneer in the field of infrastructure asset management industry. Rising as an infrastructure bank, it now covers whole range of wholesale banking activities focused exclusively on infrastructure. Macquarie today has over US\$ 300 billion assets under management, covering three continents of Asia, Europe and North America. In the region, Macquarie has a joint venture with Abu Dhabi Commercial Bank and it has set up a US\$ 1 billion ADCB Macquarie Infrastructure Fund primarily focused on Abu Dhabi's infrastructure projects.

Similarly, in Canada, Borealis is a leading manager of infrastructure funds and it manages over C\$ 53 billion of OMERS (which is the country's leading pension fund) funds, a proportion of which is invested in infrastructure assets. In the United Kingdom, a number of private equity and infrastructure asset managers are exclusively focusing on developing investment plays in the infrastructure sectors. 3i, one of the leading private equity firms in the UK, has a dedicated business arm for infrastructure investments.

The GCC region has already been introduced to infrastructure private equity as an asset class. Going forward, this asset class can be an effective tool for delivering financing to infrastructure projects across the region. Ten years ago, EMP faced difficulties in generating a sizable deal flow; however, with a plethora of infrastructure projects in the offing, deal generation may not be as challenging as it was before.

Infrastructure funds leverage on the inherent characteristics of infrastructure assets as a separate asset class. Some of the key characteristics of infrastructure assets (which make these assets attractive for pension funds and insurance companies) include:

GCC Governments can play a key role in establishing infrastructure funds

Exits: Exiting an SME investment can definitely be tough. At the moment, there are no secondary markets for trading stakes in SMEs. However, most of the SMEs are in the feeder industries and thus can become potential candidates for acquisition by companies in related domains. The family groups particularly are keen to invest in companies which are closer to their domains and of which they have a deeper understanding. Irrespective of the presence or

- Long term and better matching for the risk profile of institutional investors like pension funds and insurance companies;
- Stable returns and inflation hedged;
- High capital expenditures and specialist technologies create high and strong entry barriers;
- Usually off takers are government utilities thus reducing overall risk profile;
- Cashflows are predictable.

a. Opportunity Landscape for Private Equity Infrastructure

► Public Sector Led **Infrastructure Fund Platforms:** The combination of sizable infrastructure investment opportunities in the GCC, availability of substantial capital (particularly from the public sector) and presence of infrastructure fund management expertise in the region can be a potent launching pad for undertaking public sector led infrastructure funds. This can also be an opportunity to create unique public private partnerships whereby public funds are allocated to the infrastructure projects through privately

One of the main features of such public sector led infrastructure fund platforms could be that these could be heavily weighted towards greenfield projects where attracting private institutional capital can be tricky, especially due to significant completion risk.

managed infrastructure fund

platforms.

In addition to resident infrastructure fund managers, a number of international infrastructure fund managers can be attracted to the region for setting up these joint

platforms with the public sector. Such partnerships will not only facilitate efficient allocation of capital, but will also draw upon lessons from international experience of these fund managers in large scale infrastructure projects.

Qatar has a massive budget for infrastructure projects for the next 5-10 years. Strategic importance of these projects is even more now in the context of Qatar being the host of 2022 FIFA World Cup. Qatar has an opportunity to take a leadership role in establishing such platforms and drawing upon expertise of infrastructure fund managers in jointly implementing the planned infrastructure projects.

Private Investors Led Independent
Infrastructure
Funds: The case for independent infrastructure funds is expected to retain its

compelling proposition. Although first generation infrastructure funds in the region struggled to generate quality deal flow, this should not be an area of concern now, especially when there are a number of brownfield opportunities and cash generating infrastructure projects in the GCC. With confidence being restored in the private equity industry, independent infrastructure funds are expected to be back in business. Characteristics of infrastructure assets (as listed above) are appealing for a number of institutional investors in the region. This space can be more appealing for existing infrastructure asset managers in the region with established track record.

► Specialized Infrastructure Funds: A consortium of Islamic Development Bank, World Bank and International Finance Corporation recently appointed Emerging Markets Partnership as manager for Arab Infrastructure Investment Vehicle ("AIIV"), a US\$ 1 billion specialized fund for providing mezzanine financing facility to infrastructure projects in the Arab world, with focus on GCC, Levant and North Africa. AIIV will focus on greenfield projects. This is a very specialized proposition combining greenfield projects with mezzanine financing, an unprecedented mandate for the region.

AIIV is an example of innovation in the infrastructure financing space where an

A US\$ 1 billion mezannine infrastructure fund has recently been established for investment in Arab Countries

infrastructure fund manager's expertise is drawn upon in managing a very unique investment proposition. Although AIIV has broader economic and social objectives, the three multilaterals have taken leadership in introducing innovative mechanisms for financing infrastructure projects in the region.

b.Specific Challenges – Infrastructure Private Equity

Despite significance of opportunities in infrastructure, the proposition of infrastructure funds may face following challenges in the GCC:

► GCC governments are committed to infrastructure development in their respective countries. However, due to

public sector's strong fiscal capacity and ability to directly invest in projects, the need for private capital could be low, potentially limiting space for infrastructure funds as financing mechanisms. The above proposition of public sector led infrastructure funds do not run counter to GCC's strong fiscal state, rather it complements well with private sector's ability to allocate capital efficiently as well as specific experience and expertise in financing and managing infrastructure assets globally.

- ▶ Early stage infrastructure investments have longer gestation periods. Greenfield projects particularly will be a difficult proposition for investors. Public sector and multilaterals can be lead investors in such early stage fund propositions whereas institutions like pension funds and insurance companies can be targeted for funds targeting brownfield or cash generating projects.
- ► Infrastructure funds need to be sizeable. It is not uncommon for infrastructure funds to be of sizes, exceeding \$1 billion. Not

many infrastructure funds can be established.

The sector's

development in the GCC will depend largely on the public sector's approach towards private participation. Private capital, including that of HNWIs from the region can be attracted in these initiatives.

iv. Mutual Funds

Mutual Funds will remain one of the dominant segments of the GCC asset management industry. Going forward, it will most probably remain the largest. However, in terms of its overall significance in the economic growth of the region, its role at best will be a byproduct of the developments in other sectors of the economy and other segments of the asset management industry.

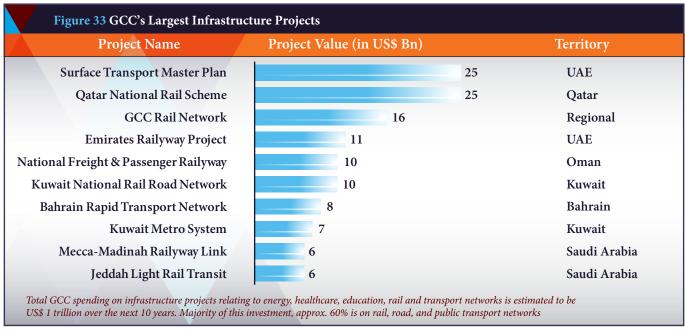
Equity funds are expected to remain dominant. The GCC stock exchanges have performed very strongly during the first quarter of 2012, recouping almost all the losses incurred during 2010. There is certain degree of optimism about potential recovery of the market. Mutual funds AuM will rise in line with the growth in market capitalization.

The CMA in Saudi Arabia is taking important steps for building depth in the Saudi stock market

A slowdown in IPO activity and low levels of floating stock put constraints on mutual fund managers' ability to construct diversified portfolios. Value addition for both the local investors and foreign investors remains to be clearly demonstrated.

The mutual funds industry will definitely get a boost from "promotion" of the Gulf markets to emerging status. In addition, renewed economic activity and a strong first quarter this year has made companies dusting off their IPO plans, which got shelved during the 2008 crisis. A combination of these events can provide strong impetus to growth in mutual funds AuM.

With CMA's new rules on allowing foreign companies to list at Saudi Tadawul and introduction of new instruments like convertible bonds, warrants etc., it is definitely aiming at broadening and diversifying the markets' base of investors by bringing new variety of financial instruments.



The Saudi market is also being planned to be open to foreign investors on a gradual basis, thereby reducing the barriers for these investors (at the moment foreign investors can buy shares in the Saudi market only through swap arrangements or some ETFs).

The other regional markets are performing well too. Dubai and Qatar are among the strongest form. All of the above developments bode well for development of equity mutual funds market in the GCC.

There are no apparent challenges to the mutual fund industry other than lack of depth and diversity in the stock markets. In addition, the investors at the moment have a heavy degree of "home bias", which if addressed, can create greater opportunities for GCC wide funds.

v. Sukuks/Bond Funds

As mentioned in Chapter 2, the market for underlying assets of Sukuk and Bond funds is robust and sizable. Despite this strength, it is difficult to conceive a vibrant market for sukuks or bond funds. The reasons are:

 Most of the sukuks and bonds will continue to be issued by banks, central banks and SWFs. They appear to be the majority issuers with a track record. Moreover, these organizations get rated regularly and particularly enjoy good ratings;

- ▶ Banks are expected to remain dominant allocator of fixed income financing. With the liquidity of banks being restored and fully backed by the government, banks will become the cheapest source of financing for the corporates;
- ► The real sign of maturity will be the emergence of midsized corporates issuing Commercial Paper (or Islamic Commercial Paper) and it is allowed to be traded.

vi. Real Estate Investment Trusts

This particular asset class is included in the list since the region has a very strong preference for real estate. The real estate boom in the UAE and some other countries in the GCC demonstrate regional demand for REIT's underlying assets.

The real estate fund industry is almost negligible at the moment. The underlying real estate market is undergoing a major shakeup and the prices are still depressed whereas the investor sentiment is overall low. There are signs of progress in certain areas in the UAE, with prices jumping 20-30% in the last 4-6 months. There are still a number of projects to be delivered.

In addition, the real estate market needs to be regulated through a whole gambit of laws including mortgage law, foreclosure law etc. Unless these laws are fully instituted across the region, a vibrant market with an international base of investors cannot be created in REIT.

Bahrain has been a forerunner in terms of introducing products and related regulations. In its new Collective Investment Undertaking Module, Central Bank of Bahrain has released for consultation the regulatory framework for new products include B-REIT i.e. Bahrain REITs.

REITs may have a chance to penetrate in this market due to investors close association with underlying asset class as well its potential yield characteristics.

Figure 34 Opportunities and Challenges of Asset Classes

Asset Classes

Private Equity Expansion & Growth Capital

+

- Interest from Southeast Asian investors
- Attractive valuations due to asset price deflation
- · Diversity of deal flow
- · Growth in capital markets
- Challenging fundraising environment
- LP fatigue
- Increased portfolio monitoring
- Fee pressures
- Adherence to investment scope
- Quality of management teams
- Governance
- Inadequate returns
- Lack of corporatization and returns
- Lack of exit options
- Limited requirements for private capital
- Early stage infrastructure investments have long gestation periods
- Low IPO activity
 - · Lack of depth and diversity

SME Funds

- Sector focused funds
- Efficiently run platforms
- Mid-Cap opportunities

Private Equity Infrastructure

- Public Sector Led Infrastructure Fund

 Platforms
- Private Investors Led Independent Infrastructure Funds
- Specialized Infrastructure Funds

Equity Mutual Funds

- Growing capital markets
- Regulations to increase activity and increase foreign participation

Source: Markab Analysis

VII

Chapter 5: The Way Forward and Key Areas of Focus for Regulators & Policy Makers

The asset management industry in the GCC has potential for multidimensional growth via consolidation of existing asset classes, introduction of new asset classes, nurturing new asset managers and attracting new financial capital from external investors.

Small, incremental steps will be insufficient. The GCC is entering a phase of major economic activity. Large scale infrastructure projects are planned throughout the key

GCC economies. Mega cities are being constructed; massive transport, logistics and tourism infrastructure is being built, world-class healthcare, sports and education facilities are underway, just to name a few. This is in addition to the continuous development of the traditional hydrocarbon sector.

All of this requires efficient flow of capital into the region and unlocking of latent value in companies and assets. More so if

the economic benefits of these developments are to cascade to the citizens of these countries - a key objective of policy makers in the region.

The asset management industry and capital markets are central enablers in achieving capital flows and unlocking latent value in assets. In order to facilitate this growth process, or rather to create an enabling environment for growth; certain high level strategic steps are required to be taken. These steps



range from structural changes in commercial companies laws to taking global leadership in the Islamic asset management domain.

Collective efforts of all the key stakeholders in the following areas will go a longway in developing the asset management industry and making it a strong engine of economic growth in the GCC region.

A. Attracting Foreign Investors and Fund Managers

There is a huge opportunity for the GCC to attract foreign investors and fund managers from all over the world.

The GCC is among the fastest

growing economic regions in the world. There are indications of investor interest from Europe and Asia to invest in the Gulf economies via investment platforms. The region is very well positioned to become an attractive destination for foreign investors.

Two global shifts are creating opportunities for the GCC region:

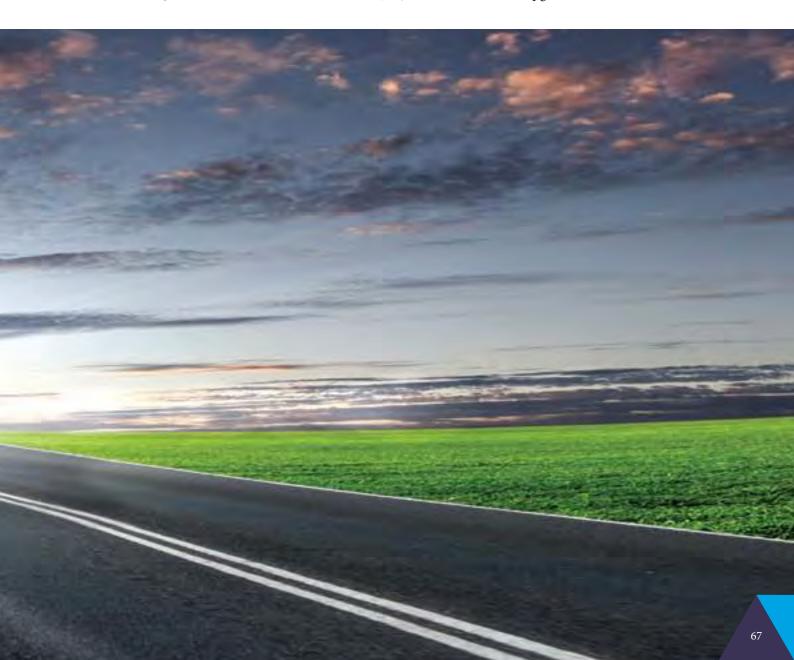
1) Europe is losing its attraction as a destination for asset managers;

2) Asian investors, who represent the new (and rapidly growing) source of investable wealth, are looking for global diversity. The GCC is under-allocated for almost all the large holders of diversified asset portfolios.

Some private equity firms are

making stand-alone efforts to attract Asian institutional investors and have achieved success as well. But standalone efforts have very high agency costs, which only a few players will be able to bear.

This is an excellent time to address structural issues related to transparency and corporate governance to further improve GCC's chances to attract investment. Although the countries are registering strong economic growth and stock markets are reasonably active, the markets are yet to be included in the list of emerging markets. Enhancing governance, transparency and efficient listing process will be instrumental in fetching this upgrade.



The GCC countries have close trading links with China and other Southeast Asian countries. The region should leverage on its strong relationships with the new Capital Markets Authority is streamlining listing regulations to allow participation of foreign investors and listing by foreign companies.

Laws relating to foreign ownership of companies in the GCC need to be streamlined

economic superpower. Chinese financial institutions are flush with liquidity and they are seeking new investment opportunities outside China.

Attracting best of class global expertise will be very constructive in developing the industry. Singapore has managed to create a vibrant and sizable asset and wealth management industry. The GCC should draw lessons from Singapore and other Asian financial capitals to develop its financial hubs.

B. Creating an Ecosystem

The asset management industry is not simply an interaction between investors and asset managers. It is an entire ecosystem of capital providers, skilled professionals and efficient regulators interact closely to efficiently allocate capital.

The GCC countries need to build ecosystems, which brings together bankers, asset managers, investors, regulators, lawyers, accountants, rating agencies, scholars, Shariah advisors, brokers, consultants, auditors, training institutes etc.

The building blocks are in place. DIFC and QFC have world class regulations. Bahrain has a unified regulatory model, and the Central Bank of Bahrain is known to be a strong regulator. Saudi Arabia's

The progress in laws and regulations is impressive. The GCC region on an overall basis has made substantial

changes in regulatory frameworks for asset management firms and capital markets. Capital Markets Authority in Saudi Arabia, formed in 2003, has successively introduced a number of laws and regulatory frameworks to streamline wholesale banking, regulate mutual funds industry, control issuance of capital, rationalize listing regulations and issue licenses to brokerage companies. Dubai and Qatar set up dedicated financial centres with their own regulatory frameworks, in line with international standards. Central Bank of Bahrain, maintaining its reputation as one of the most proactive central banks in the region, issued new guidelines for Collective Investments Undertaking to regulate the fund management industry. It also consults all stakeholders on draft regulations prior to issuing the regulations.

All of these changes are progressive and have made positive contributions towards the health and integrity of the asset management space.

Another key area where financial centres can play a role is to bring about improvement in corporate governance. The GCC region is perceived to lag behind many territories in corporate governance. Investors will be much more comfortable in investing with better

regulated asset managers.

However, financial centres or banking regulators alone cannot build the ecosystem. They would need a broader buy-in and support from the State to have the support infrastructure in place. For example, streamlining of visas for attracting global talent will require State support. Within the GCC, the DIFC's success is partly driven by its ability to create a one-window operation for an asset manager to set up operations.

C. Reforms in Ownership laws

Perhaps, the biggest constraint in the growth of the asset management industry is the issue of opaque regulations relating to foreign ownership. The GCC's traditional ownership model is that at least 51% ownership needs to be held by the national of the respective GCC country. In actual practice, economic ownership is often completely different from the legal ownership. Foreign investors put in up to 100% of the capital and take the entire business risk in return for 100% profit. The local partner is paid a sponsorship fee for being a 'silent' partner. In the past ten years or so many hybrid models have emerged, most notable of which are free zones. At present, the GCC countries are at varying levels of transition to a 100% foreign ownership model.

The fundamental issue is that ownership laws are opaque. Free zones (in the UAE) allow 100% ownership but there are limits to their mandate. Qatar has opened up some sectors for 100% ownership, though actual approval is at the sole discretion of the Ministry of Business & Trade. Saudi Arabian General Investment Authority (SAGIA) allows 100% ownerships if the Company is incorporated under

SAGIA regime.

Given lack of flexibility in the corporate laws and the opaqueness of ownership, asset managers have had to devise ways around these issues. There are structural solutions available supported with some (mostly untested) legal grounding. However, in an increasingly global financial world, in order to keep up with the other emerging financial centres and to facilitate long term growth of the asset management industry, GCC's on shore corporate laws need to have appropriate revisions.

The misalignment of legal and economic ownership can best be addressed through flexibility of ownership. It is not necessary that the GCC countries allow a carte blanche 100% ownership right in all sectors. However, unified regulation (in each country) and legally enforceable ownership model will remove a big hurdle in foreign investments.

Flexibility in ownership structures need to be introduced to facilitate structuring and closing of transactions onshore. This will enhance confidence of local investors. For example, some investors would like to have extra rights on shares customary for private transactions. These rights may include voting/non-voting, drag-along, tag-along rights etc. At this point, due to lack of proper corporate on-shore structures, all of these structures are constitutionalized in off-shore jurisdictions.

D. A Hub for Islamic Products

In the past few years, the demand for Shariah products and Islamic Finance has grown at an astronomical pace. Within the GCC region, financial institutions have been introducing Shariah products and Islamic windows. While Shariah compliant mutual funds have been introduced, Sukuks (or Islamic bonds) are now becoming a key fixed income product.

The demand for Shariah compliant products is expected to continue to rapidly grow and the GCC investors are expected to be the biggest holders of Islamic products. The GCC has the largest pool of wealthy Muslim population and a Sharia based legal code; it is natural that the GCC region is the hub of Islamic finance and investment. The latent demand for Shariah compliant products is sizable and yet to be explored. The demand is not limited to GCC investors. Muslim investors all over the world are increasingly seeking Islamic investment products.

Despite this demand and supply surge, a central hub for Islamic asset management is yet to be established. Over the years, a large base of investors, institutions, fund managers, scholars, lawyers, advisors etc. has been established. However, they are largely fragmented.

Islamic asset management has now become so sizeable that Singapore though not a country with a large Muslim

population or Islamic banks, is seeking to establish itself as a hub for Islamic asset management.

The financial centres in the GCC are naturally positioned to capitalize on this space and become a hub for Islamic asset management for investors worldwide.

E. Collaboration with the Private Sector

Some sectors are critical to the

growth of economy and employment. There is an increasing focus towards the development of the venture capital and SME sectors. In most established regions of the world, the SME sector is the biggest source of employment.

The government can bring private sector investment talent to support the development of these two sectors. SME and venture capital funds can operate much more efficiently if investment management is undertaken by good quality investment teams.

Similarly, governments can also establish infrastructure funds in collaboration with the private sector.

Even if capital commitment is not involved, closer discussions with the asset management industry would be beneficial for policy makers. sector

F. Maintaining Value Proposition of Multiple Financial Centres

The GCC region already has multiple financial centres. Each financial centre is capable of

The asset management industry can help unlock latent value in companies and be a catalyst for efficient flow of capital into the region

building its own unique value proposition. The market is still large enough to accommodate multiple financial centres (US alone has 10 financial centres), so long as each centre has a defined niche. It is in the long term interest of the region to work cohesively and carve out roles for each centre. The financial services industry is diverse and offers a range of opportunities. The major financial centres would need to find ways to complement each other.

VIII

End Notes

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- 2 The Economist Hedge Fund Research
- 3 Source: The Wall Street Journal
- 4 Source: Hurun Rich List, Daily Telegraph; 271 in China / 400 in the USA.
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- 8 Source: The LA Times, Financial Times
- 9 Source: EU Inside, Markab Research
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- Source: The City UK Fund Management Report, PWC US Asset Management Industry Report, Markab Analysis
- Source: Markaz Sector Report, Zawya Fund Fact Sheets
- 14 NMC, one of the leading healthcare companies based in the UAE has recently listed its shares on London Stock Exchange, citing advantages of liquidity and a broader base of institutional and retail investors. Shifting of IPOs of regional companies to other markets signify overall crisis of confidence and low investor sentiment.
- 15 Source: Markaz Sector Report, Zawya
- 16 Central Banks typically issue debt instruments for managing domestic liquidity

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- 19 Source: World Bank Data, Markab Research & Analysis
- 20 Source: Markaz Sector Report
- 21 Source: Zawya
- Quoted at lecture given at the Madinah Institute for Leadership & Entrepreneurship, 13December 2011
- 23 For the purpose of this report, venture capital in the region is defined as the provision of long-term equity investment by financial investors in innovative and scaleable companies at early to mid-growth stage. It does not include seed and angel investments, and is not solely confined to technology investments; however technology is typically the key factor that creates the potential scaleability of the deal.
- 24 Cumulative funds raised by VCs in MENA since 2000, Source: MENA PE Association, Zawya
- 25 Source: Markaz Sector Report, Zawya
- 26 Source: Bloomberg, Zawya
- For the purposes of this document, the scope and coverage of private equity industry includes typical buyout funds, SME funds and infrastructure funds.
- 28 Source: Markab Research
- 29 Source: Markaz
- 30 Source: Markaz



Markab Advisory is a management consulting firm, headquartered in Dubai. Markab provides consulting services across the GCC region.

Markab brings a deep understanding of the GCC region. Its partners have spent over 25 years in this region, providing a range of consulting services to its clients. Markab assists its clients in building sustainable competitiveness by helping them gain better knowledge of their ecosystems and effectively deploy capital, knowhow, people and technology.

Research and insightful analysis are central to Markab's practice. It continuously strives to build its knowledge capital focusing mainly on its core territories. Its team have developed a deep understanding of key sectors and sub-sectors in the GCC region.

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