GIBSON DUNN

April 29, 2019

INVESTMENTS IN MENA-BASED ASSETS: PLEASE PROCEED TO THE EXIT IN AN ORDERLY FASHION

To Our Clients and Friends:

Following the influx of capital into the MENA region in the last two decades, private equity (PE) firms and institutional investors who acquired businesses during that period, and who generally hold on to such assets for a period of 3-7 years, are now seeking to divest these assets and provide returns to their investors. Whilst more developed regions have a strong track record of successful exits, exits from investments in MENA based assets are traditionally more difficult to realise. This article sets out a number of methods to streamline exit processes and potentially increase returns.

TURNKEY TRANSACTION

The timeframe for the execution phase of a non-complex PE sale transaction (i.e. the period between entering negotiations on a term sheet and closing the deal) is often significantly longer in MENA than it is in developed markets. Even with the best of intentions, it is not uncommon for simple dispositions in the MENA region to drag on for nine to 12 months and regularly it takes much longer. To help shorten this timeframe, private equity and corporate sellers alike should pre-empt issues and attempt to provide the purchaser with a potential "turnkey transaction".

Pre-sale diligence and clean-up

The first step in offering a turnkey solution is ensuring that the target group undergoes an extensive vendor due diligence review prior to taking it to market. From a legal perspective, this review should usually include (as a minimum): (i) ensuring that each member of the target group has the requisite licences to operate in its jurisdiction of operation; (ii) simplifying the corporate structure of the target group to make the disposition smooth and marketable; (iii) renewing commercial contracts with key customers and suppliers; (iv) ascertaining (and minimising) which counterparties of the target group's commercial and financial arrangements will be required to consent to the transaction; and (v) setting up and maintaining a well organised virtual data room.

Identifying and resolving issues prior to entering into a formal sales process ensures time is not wasted trying to solve them contractually later in the process. Preparation of a vendor due diligence report also means bidders do not have to carry out due diligence cold. Undertaking these steps prior to going to market will streamline the process to signing, reduce the number of conditions precedent and specific indemnities requested by potential purchasers (which will leave the seller in a stronger negotiating position) and limit the time from signing to completion. Taken together, this should result in significant cost savings. Additionally, a well organised and structured corporate group, with a limited number of identified issues, will be a more attractive proposition for purchasers and could lead to higher asset valuations.

W&I insurance

A pre-negotiated warranty and indemnity insurance policy is now commonly offered by private equity sellers in developed markets and is emerging as a tool in the MENA market. Whilst its prominence in the region is growing, it is still somewhat of an unknown option for many market participants. To give this issue context, generally speaking, PE sellers will not give warranties or indemnities except as to title and any SPV seller will immediately distribute the proceeds to investors. As a result, the purchaser will have limited recourse for any claims under the SPA. Comprehensive W&I insurance can help to bridge this gap, giving purchasers the security they need and allowing the seller to determine its internal rate of return on the transaction on completion and to distribute the proceeds to its investors without delay. With a stapled W&I policy in place, negotiations of the SPA warranty package are also often more efficient, although W&I insurance providers will be reluctant to insure a one-sided suite of warranties based on limited due diligence.

Stapled financing

Another option to facilitate a smooth exit is for the seller to arrange stapled financing. Essentially, stapled financing is a financing package pre-arranged by the seller and its advisors prior to going to market, which is then offered to potential purchasers. This form of financing offers both sellers and purchasers a number of advantages. Although in more developed jurisdictions the debt markets are relatively competitive and acquisition financing is more easily attainable, in MENA obtaining acquisition finance has, historically, often been somewhat challenging. Stapled finance packages offer potential purchasers easier access to debt they may otherwise have found very difficult to raise, especially in a truncated timeframe. Importantly, stapled financing also provides an indication of the expected sale price as it demonstrates the debt multiple the business can sustain. In an auction process (further discussed below), offering stapled financing means there could be an increase in the number of fully funded bidders, which should increase competition and potentially lead to a higher sale price. In a transaction with a split signing and completion, offering stapled financing also provides increased deal certainty to the seller by reducing the risk of the successful purchaser being unable to fund the transaction at completion. For purchasers, stapled financing can help streamline the process of securing acquisition financing. Even if a successful purchaser decides not to move ahead with the stapled terms as offered, from the outset of the transaction they should have a well negotiated facilities agreement and term sheet which they can build on and potentially use to negotiate better terms. This should save the potential purchaser a considerable amount of time and effort and reduce their legal fees.

SECONDARY BUYOUTS

In the first half of 2018, secondary buyouts (i.e. a disposition of an asset by a financial sponsor or PE firm to a different financial sponsor or PE firm) accounted for over 40% of all dispositions by PE firms in the US. The proliferation of secondary buyouts has been a growing trend in developed markets since 2010, but it is fair to say that this has not yet extended to the Middle East. Indeed secondary buyouts are relatively rare. There are two primary reasons for this: (1) there are fewer players in the market; and (2) there is possible mistrust between competitors. Potential purchasers fear that the seller will have extracted most of the value from the asset prior to the sale and sellers fear that the purchaser may be able to re-sell the asset within a short timeframe for a significantly higher price.

Although there is nothing you can do to increase the number of players in the MENA PE market, there are several methods that sellers can employ to alleviate both their own trust concerns and those of a potential PE purchaser. The first is the inclusion of “anti-embarrassment” provisions in the share purchase agreement. Anti-embarrassment provisions require the purchase price of the secondary buyout to be recalculated and to be subject to an upwards adjustment if the purchaser sells on the asset at a higher price within a certain period (normally 1-2 years) following completion of the original transaction. Although anti-embarrassment provisions are less common than they used to be in more developed markets, as asset prices are generally quite stable, market participants have strong relationships and short hold periods are relatively uncommon, this could be a useful tool in MENA where the market is more volatile.

To assuage the concerns of potential purchasers that the value of the asset has been maximised and there is no further ‘upside’ available, sellers could also consider rolling-over a small stake in the business (e.g. 10 to 20%), showing faith in the future of the business and aligning themselves with the buyer. If rolling-over a stake in the asset, it will be necessary, however, to ensure that this is permitted under the relevant fund documentation of the seller and to include appropriate minority protections (i.e. tag rights) under a shareholders’ agreement or similar arrangement. It is also important for a seller who is rolling-over to trust the buyer and understand the only realistic option for selling the rolled-over stake will be to exit on the buyer’s terms.

RUNNING AN EFFECTIVE AUCTION PROCESS

Studies have shown that where there is competition for a business the best way to maximise a financial investor’s return on any investment can be to run the exit process as an auction, rather than as a bilateral sale process. The benefits of this are clear: more potential purchasers come to market, which leads to increased competition, which should lead to a higher sale price. However, while a failed bilateral sale is a private matter, an unsuccessful auction process may become widely known in the market, which could result in other potential purchasers becoming wary of the asset. To try to prevent this from happening, sellers should ensure they run their auction process efficiently and with appropriate ‘gates’ at different stages of the process (such as letters of intent or non-binding indicative bids). This also allows for a pre-emptive bid to emerge should that be available.

During the preparation stage of the auction process, the seller or its investment banking team on the transaction should consider the bidder universe, identify those bidders (both financial and strategic) that might be key players in an auction, and be comfortable that those invited to participate will participate meaningfully in the process. Usually they will circulate a teaser containing a limited amount of financial and other information on the business before bidders formally enter the auction process. If there are insufficient meaningful bidders to create competitive tension, the seller will lose its leverage in the process and the advantage of running an auction process is gone. Throughout the auction sale, in order to ensure the potential purchasers maintain discipline, and provided there is competitive tension it is vital to stick to the timeline and process set out in the process letter and remove those parties from the process who fail to do so.

The non-disclosure agreement (NDA) will be the first legal document prospective bidders will see in an auction so it is likely to set the stage for the whole process. To help limit legal costs, the NDA should contain market standard terms that will not need to be heavily negotiated (when sending this document to prospective bidders, it is useful to inform them as such). Before moving on to the initial bidding stage of the process, the seller should instruct its legal advisors to prepare a well advanced, reasonably commercial template share purchase agreement (and shareholders' agreement if rolling-over a stake in the business). This will help to prevent the legal costs of the transaction from spiralling and portray to potential bidders that the seller is a professional outfit who is looking to run an efficient, fair process and enter into a market standard transaction. Few things frustrate a bidder (and their legal advisers) as much as an unreasonably one-sided first draft SPA.

When reviewing initial bids, the seller and the financial advisers should be careful to balance the desire to keep as many potential bidders in the process as possible with the need to ensure only qualified (by reference to the criteria set out in the process letter) and serious bidders move to the next stage of the process, when the potential bidders will receive access to the data room. It is not uncommon for companies to enter auctions primarily in order to gain confidential information on a competitor. Moreover, if the process is competitive, the seller should restrict the number of questions that bidders can submit to the management team (based on their due diligence findings) to ensure only those which are material need to be answered. Often bidders submit an excessive list of questions many of which are unnecessary and answering them can become a drain on management and lead to the incurrence of excessive legal fees. The inclusion of a vendor due diligence report in the data room should also help to limit the number of questions bidders and their advisers feel the need to ask.

In the final stage of the auction process, the seller should seek to limit the exclusivity period provided to any final bidder and move to signing as soon as practicable (ideally within 24/48 hours). A shorter timeframe will add pressure on the purchaser to finalise the deal and will also leave open the option of returning to one of other bidders as a 'white knight' if the deal with the final bidder falls through.

CONCLUSION

In a market where successful sales by PE firms and financial institutions are difficult to come by, it would be prudent for sellers to consider implementing some (if not all) of the steps outlined above to streamline the transaction process, increase competition and maximise the consideration received in an exit situation.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding the issues discussed in this update. Gibson Dunn has been advising leading Middle Eastern institutions, companies, financial sponsors, sovereign wealth funds and merchant families on their global and regional transactions and disputes for more than 35 years. For further information, please contact the

Gibson Dunn lawyer with whom you usually work, or the following authors in the firm's Dubai office, with any questions, thoughts or comments arising from this update.

Fraser Dawson (+971 (0)4 318 4619, fdawson@gibsondunn.com)
Ciarán Deeny (+971 (0)4 318 4622, cdeeny@gibsondunn.com)