

THE PRIVATE EQUITY
REVIEW

SEVENTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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REVIEW

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PREFACE

The seventh edition of *The Private Equity Review* follows a turbulent and at times nerve-racking 2017. It was also a year in which private equity demonstrated its strength as an asset class in spite – perhaps because – of that turbulence. Deal activity and fundraising were strong in almost every major market despite fierce competition from public strategic buyers and strong returns in other asset classes, demonstrating private equity’s ability to adapt quickly to changing conditions to find profitable investment opportunities. As a result, we expect private equity will continue to play an important role in global financial markets, not only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less-established geographical markets to continue, although recent protectionist trends remain a risk factor.

While no one can predict how 2018 will unfold, one can confidently say that private equity will continue to play an important role in the global economy, and will likely seek to expand its reach and influence. It remains to be seen how local markets and policymakers respond.

Private equity professionals need – now more than ever – guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 27 different countries, with observations and advice on private equity deal-making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this seventh edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2018

Part I

FUNDRAISING

SAUDI ARABIA

*James Stull, Macky O'Sullivan and Sayf Shuqair*¹

I GENERAL OVERVIEW

Saudi Arabia is widely considered to be a country flush with cash due to abundant oil reserves and large state coffers. While there is some truth to this belief, the country is currently in a state of transition as oil prices approached their lowest prices in decades during 2016 and 2017. Reduced oil output in compliance with OPEC's oil production cut agreement, low oil prices and reduced government support led the Saudi economy to contract in 2017 for the first time since the height of the global financial crisis in 2009. According to preliminary figures, gross domestic product contracted 0.7 per cent in 2017, in contrast to the 1.7 per cent rise in 2016. Economic analysts expect the economy to return to growth in 2018 due to higher oil prices, renewed fiscal stimulus and strong global demand. However, higher inflation due to the introduction of VAT, capped oil production and mounting geopolitical risks threaten the recovery.

This current economic landscape has been a double-edged sword for the Saudi Arabian private equity fundraising environment as investors are moving away from local listed equities, which, along with local real estate, have been the asset classes of choice for Saudi investors, towards alternative asset classes. However, at the same time, many Saudi investors have much less liquidity, having lost substantial amounts in local investments over the past two years, and are reticent to invest in funds structures.

As such, many sponsors and managers have found fundraising to be difficult in 2017. This difficulty is also exacerbated by the fact that very few regional asset managers and private equity funds with considerable track records exist, which is a key factor in successful fundraising.

Fundraising levels have declined for a number of reasons in addition to the current macroeconomic situation, including the decline in the popularity of the typical blind pool fund structure and the increase in popularity of the 'deal by deal' approach to fundraising. There also seems to be a trend in the Middle East region, and Saudi Arabia in particular, for large family offices and institutional investors to increasingly prefer direct co-investments and, to some extent, managed accounts.

The landscape for local domiciled investment funds is arguably more developed in Saudi Arabia than elsewhere in the MENA region and has proven to be resistant, to a certain extent, to the overall economic and geopolitical developments in the region. This may be in part driven by the Saudi Arabian Capital Market Authority's (CMA) opening

¹ James Stull is a partner, Macky O'Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP.

of the capital markets and funds industry to foreign investors and the introduction of new, clearer and more investor-friendly regulations. As mentioned, local listed equities funds have long been the dominant product in Saudi Arabia; however, there has been a clear shift in investor sentiment toward alternatives. Private equity funds focused on certain key sectors, such as healthcare, education and consumer goods, as well as real estate private equity fund, particularly income-generating funds have performed well and have successfully closed in the past year.

The local turbulence within Saudi Arabia has led many investors to look outside of Saudi Arabia towards the UAE, and to a larger extent to Europe and the United States, which despite the geopolitical events in those jurisdictions, are widely seen as significantly more stable than Saudi Arabia. This sentiment has not gone unnoticed by foreign asset managers who are increasingly approaching high net worth individuals, families, sovereigns and institutions and marketing their foreign funds as being better alternative investments vehicles to those available in Saudi Arabia (which has experienced a turbulent past year).

The high number of foreign managers coupled with the relative inexperience and limited track record of local managers has resulted in the local managers struggling to raise private equity funds. Only the 'elite' local managers are regularly able to complete fundraising successfully. Second-tier managers are often able to syndicate specific deals (with a fully paid-in capital contribution structure) to a small group of target investors but are not capable of raising blind-pool funds.

Regardless of whether a manager is establishing a large blind-pool private equity fund or syndicating a single transaction, the CMA treats all private non-real estate funds in the same manner in terms of registration process. Funds can only be established by 'authorised persons' licensed by the CMA to manage assets. The managers must submit the fund's offering documents for a 15-business-day no-objection period. Assuming the CMA does not object to the offering, a locally domiciled fund may be offered for a one-year period during which the fund manager would typically secure the necessary capital commitments and launch the fund. Fund managers launching single asset funds have generally successfully secured the necessary capital within the one-year period and held the closing of the fund. Blind pool venture capital and private equity funds raising has taken substantially longer and required multiple closings. Most of these funds have not been able to raise the target funds during the one-year period, and as such, managers have had to seek an express exemption to offer beyond the statutory maximum period.

Fundraising in Saudi Arabia, as is the case elsewhere in the region, is challenging for many market participants due to the relatively small number of fund managers with an adequately robust track record – particularly successful exits. As such, investors prefer to subscribe to transactions on a deal-by-deal basis rather than via the blind-pool structure seen in more developed markets. The main benefit of the deal-by-deal approach is that investors are more assured of the growth prospects and corporate governance of the underlying investment target, and are therefore more comfortable with committing significant capital to a transaction. However, strengthening deal flow powered by a growing number of maturing family businesses in Saudi Arabia may see the demand for general private equity funds grow in number in the near future and Saudi CMA funds compete with other regional funds in terms of fundraising. Further, over the past several years, venture capital activity has dramatically increased in Saudi Arabia, and due to the small deal size, deal-by-deal investments are impractical and investors have participated in such blind-pool funds (although the average ticket size tends to be small).

II LEGAL FRAMEWORK FOR FUNDRAISING

With just under 300 privately placed funds and a similar number of publicly offered funds in the Kingdom, Saudi Arabia is the most popular jurisdiction in the region for locally domiciled investment funds. Such success may be attributed to a number of reasons, including the competence of the CMA as the regulator of investment funds in Saudi Arabia.

The regulations governing the formation of investment funds have been evolving since the first rules governing mutual fund activity were introduced in 1993. The latest amendments to the Investment Funds Regulations, which became effective in November 2016, streamlined the process for establishing a fund and removed a number of restrictions on private offerings. These amendments are generally viewed as investor-friendly.

A CMA fund is a contractual entity formed between the fund manager and its investors upon execution of the terms and conditions (the form and contents of which are specified by the Investment Fund Regulations). The terms and conditions are the equivalent of a limited partnership agreement for a fund established as a limited partnership or the articles for a fund established as a company. A Saudi Arabian fund may only be established by an entity licensed by the CMA as an authorised person licensed to carry out management activities. The CMA issued new regulations in October 2017 relaxing the process and requirements for applicants to obtain a management licence and dramatically reducing the required share capital (in some cases to as little as 5 million riyals).

Under CMA regulations (and from the perspective of other Saudi governmental authorities and ministries), a Saudi Arabian fund is not considered to be a separate legal entity from the fund manager. Accordingly, the Saudi Arabian Ministry of Commerce and Investment (MoCI) will not issue a commercial registration to a fund (which is a requirement to own shares in companies and other assets in Saudi Arabia such as real estate). Therefore, all actions of a CMA fund must be performed by the fund manager and all assets must be owned by the fund manager or custodian (or special purpose vehicle established by the foregoing).

In contrast with the MoCI, the CMA considers a Saudi Arabian fund to have a separate legal personality and existence from its manager. However, it is unclear whether all Saudi courts and other governmental authorities take the same position. In the past, certain governmental authorities and regulatory have not seen a fund as an entity distinct from the fund manager.

Because funds are contractual entities regulated by the CMA only, and not the more restrictive MoCI, funds may provide investors with certain rights and obligations that are not otherwise available under the more typical investment vehicle structure of a limited liability company. Such provisions include capital commitment structures, default remedies, dilution, forced exits and redemptions.

The offering documents of a CMA private equity fund (which include the terms and conditions and private placement memorandum) follow a prescribed form that is set forth in the Investment Funds Regulations. The CMA included a prescribed set of provisions that must be disclosed, which include the investment objective, description of underlying asset, investment strategy, risk factors, fee structure, subscription and redemption processes, valuation mechanism and investor reporting requirements. With the recent amendments that have been introduced, it is clear that the CMA's position as a regulator is shifting from a more manager-friendly position to an investor protectionist position. In addition, the investors themselves, particularly institutions, sovereigns and large family offices, are becoming increasingly sophisticated and are negotiating certain provisions that historically were not negotiated as much, including those related to fees and allocation of units post-closing.

In terms of fundraising and solicitation of investors in Saudi Arabia, it is common for local private equity funds to solicit investors through a typical road show process after the lapse of the CMA's 15-business-day review period. Such funds need to be offered by a CMA licensed manager. For foreign funds, interests may be offered following the lapse of a 10-business-day review period by a promoter licensed by the CMA with an arranging licence. The foreign offeror may not offer the securities directly in Saudi Arabia.

Certain requirements, such as satisfying a minimum investment amount requirement of 1 million Saudi riyals by the investor, must be satisfied in order the funds to be offered and sale to be consummated. Further, the foreign fund manager must be authorised in a jurisdiction that employs regulatory standards and requirements at least equivalent to those of the CMA and the CMA shall have the discretion to assess whether the jurisdiction has equivalent regulatory standards and requirements. It is unclear whether managers established in many offshore jurisdictions would meet these criteria, although the CMA regularly allows for funds domiciled in major offshore jurisdictions to be offered in Saudi Arabia. The distributor must provide an undertaking to the CMA that the offering documents are true, accurate and not misleading – which means that the distributor will generally want to perform a certain level of diligence on the fund and manager as the distributor does not want to make false statements to the CMA. The distributor must submit a report to the CMA of all Saudi investors that subscribed for units in the fund.

Under the Investment Funds Regulations, the manager of a Saudi Arabian private equity fund has a fiduciary duty towards the fund's investors which includes the duty to act in the best interests of the investors and a duty to exercise all reasonable care and skill. Further, under the Authorised Persons Regulations (which govern licensing of fund managers in Saudi Arabia), the manager of a Saudi Arabian fund also has the following fiduciary duties: (1) loyalty: a manager must act in all cases in good faith and in the interests of the investors, (2) conflict of interest: a manager must ensure that it safeguards at all times the interests of the investors and that no conflict of interest between its interest and the interests of the investors affects the services that the manager is carrying out, (3) no secret profits: a manager must not use the customer's property, information or opportunities for its own or anyone else's benefit unless full disclosure of such usage to the investor is made and consent is obtained, and (4) care, skill and diligence: a manager owes the investors a duty to exercise the care, skill and diligence that would be exercised in the same circumstance by a person having both the knowledge and experience that may reasonably be expected of a person in the same position as the manager; and the actual knowledge and experience that the manager has.

III REGULATORY DEVELOPMENTS

The CMA and the Saudi Arabian Monetary Authority (SAMA) are the governmental bodies that regulate asset management and financing transactions in Saudi Arabia, while the Saudi Arabian General Investment Authority (SAGIA) governs foreign investment. To date, the SAGIA rules have not governed foreign ownership in a CMA fund, and there is no requirement that non-GCC investors in a CMA fund obtain SAGIA approval. A foreign investor's ownership of units in a CMA fund is only governed by the rules and regulations of the CMA.

The CMA introduced the amended Investment Funds Regulations in 2016 with the hope that they will provide clarity and encourage more managers to launch funds. The CMA had intended for years to revamp the Investment Funds Regulations to address problems of

investor protection, which arose during the financial downturn, and to cover the launches of a diverse range of new funds, many of which were not contemplated by the 2006 regulations (and in fact introduced similar draft regulations in May 2013 that were ultimately not adopted).

In addition, and as a matter of practice, the CMA has increasingly scrutinised blind-pool investment funds and real estate development funds. Due to this heightened scrutiny and the relative ease with which managers can establish private CMA funds, there has been a significant shift toward single asset funds, particularly single asset real estate private equity funds with very limited numbers of investors.

The CMA has been encouraging many of the country's blue-chip and large family-operated companies and financial services companies to list and has also created a small cap-market (the Parallel Market or Nomu) in February 2017 which has seen over a half dozen listings in its first few months. This move was widely anticipated and well received, and improves access to capital for SMEs and encourages better corporate governance. Further, Saudi Arabia introduced a real estate investment trust (REIT) regime and in November 2016, Riyadh REIT was the first REIT to be listed in Saudi Arabia (and only the second REIT to be listed in the Middle East) and was followed by approximately a dozen other REITs by January 2018. In general, listings and capital raises in Saudi Arabia have continued to be strong over the past year, while capital markets in other regional and oil-driven economies have dried up.

Throughout 2016 and 2017, the CMA has released numerous regulations covering the establishment of new corporate vehicles, the IPO process and foreign investment in Saudi Arabia and has promised a complete revamp of existing financial services regulations. Three regulations in particular are pivotal for asset managers looking to raise Saudi Arabia targeted funds: the proposed rules on the offer of securities and continuing obligations and the amended investment fund regulations. These new regulations provide opportunities to investment banks, private equity firms and asset managers to expand their product offerings and access additional investor bases.

On 9 January 2018, the CMA issued the amended Rules governing Saudi Arabia's Qualified Foreign Investor (QFI) framework (Rules), which are effective as of 23 January 2018. The amended Rules aimed at easing the qualification requirements for qualified foreign investors, their affiliates, foreign portfolio managers and their managed funds, and expanding the range of institutional investors eligible under this framework. Key changes to the existing Rules include:

- a* eliminating the requirement for the CMA's review and approval of the QFIs' qualification;
- b* lowering the assets under management or custody (AUM) requirement for QFIs from US\$1 billion to US\$500 million;
- c* qualifying the affiliates of QFIs or foreign portfolio managers and their managed funds without the need to submit separate applications; and
- d* easing some of the continuous obligations requirements on QFIs.

Tax in Saudi Arabia is administered by the General Authority of Zakat and Tax (GAZT). Under the Saudi Arabian tax regulations, private equity funds are treated as 'capital companies', which means (1) they are subject to a 2.5 per cent tax on wealth to the extent the fund is owned by Saudi Arabian nationals or nationals of other countries of the Gulf Cooperation Council (GCC), (2) they are subject to a tax on profits of 20 per cent to the extent the fund is owned by non-GCC investors, and (3) the fund is required to pay a withholding tax of 5

per cent on payments of all dividends and capital gains to investors. However, since 2006, the GAZT has not assessed any taxes on private equity funds in Saudi Arabia or the investors in those funds. This is not a formal exemption and GAZT has reserved the right to begin taxing funds at any point in the future (including on a retroactive basis). Following a public consultation in July 2017 and August 2017, Saudi Arabia released final value added tax (VAT) regulations through the GAZT website on 29 August 2017. VAT was introduced at a standard rate of 5 per cent on 1 January 2018.

As of today, non-resident investors in Saudi Arabian funds are not subject to tax and payments by funds in Saudi Arabia to non-resident investors are not subject to withholding taxes. That being said, investors and managers in Saudi Arabia should be aware that while funds are currently tax-free, the GAZT has reserved the right to tax funds as if they were companies at any time and on a retroactive basis.

During 2016 and 2017, the CMA has issued a number of new regulations intending to encourage foreign investment in Saudi Arabia and to stimulate banks and managers to grow assets under management by tapping retail markets and international investors. The CMA also wants to encourage managers to develop products which can be accessed by the Saudi public in order to encourage individuals to invest their income in the Saudi domestic market. As such, over the past two years, the CMA released numerous regulations covering the establishment of new corporate vehicles, the creation of a small-cap market, amendments to the IPO and book-building processes and the easing of the foreign investment requirements into listed equities and funds in Saudi Arabia. In addition, the CMA has promised a complete revamp of existing financial services regulations.

In particular, the amendments to the funds regulations are pivotal for asset managers and sponsors seeking to raise funds from the Saudi market. After a consultation period, the new funds regulations were released in May 2016 and became effective on 6 November 2016. The new funds regulations govern the formation, offering and operations of all private and public investment funds in Saudi Arabia, except publicly offered real estate funds. The issuance of the new funds regulations was long expected as the CMA had publicly acknowledged for years that new regulations were in progress.

The CMA intends the new fund regulations to provide clarity and to encourage more managers to launch funds. The CMA has intended to revamp the prior regulations in order to codify unwritten practices of the CMA, to address problems of investor protection that arose during the financial downturn and to cover the launch of a diverse range of new funds, many of which were not contemplated by the earlier version of the regulations. The process for launching a private equity fund or venture capital fund remains essentially unchanged, although the required documentation has been detailed.

There are a number of other provisions of interest. First, the fund manager may not restrict investors of certain nationalities unless the approval of the CMA is obtained. The CMA has indicated that the only restrictions it will apply will be to restrict those private real estate funds that invest in the cities of Mecca and Medina to Saudi Arabian nationals only. Otherwise, all investment funds would be open to foreign investment, regardless of the underlying investments. This is a significant change as it was often considered a grey area whether foreign investors could invest directly into CMA-regulated funds or if such investors would be prohibited or would have to register through a lengthy process with the Saudi Arabian General Investment Authority. Second, there is no strict requirement to have a fund board for a private investment fund, which in the prior regulations was a statutorily mandated oversight body. This provides managers with more flexibility when it comes to

structuring fund governance, but potentially removes protection for investors. Third, under the prior regulations, the maximum number of investors that could be approached in a private placement was 200, but the new regulations do not contain a limit on the number of investors that a manager may approach in a private offering. It was widely hoped that the new funds regulations would set out certain exemptions to the requirement to register funds with the CMA; however, none were provided for locally domiciled or foreign funds.

IV OUTLOOK

The CMA is currently reviewing all financial services regulations and trends in Saudi Arabia and is in the process of a massive overhaul of the funds and asset management regulations. This is part of an effort to grow, modernise and diversify the Saudi Arabian economy and to spur foreign investment and new products in Saudi Arabia. While the CMA is a stringent regulator, the funds industry in Saudi Arabia has been a success story compared with the rest of the GCC, and locally domiciled funds have flourished. The CMA and other regulators have encouraged this growth and stability, and have been revolutionising the structuring of private equity in Saudi Arabia. As such, it is expected that Saudi Arabian markets will continue to expand in the coming year despite some of the regional economic turbulence and slump in the price of oil.

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