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International Insights: Deal-making in the GCC

Global Webinar

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GCC features and objectives

GCC features and objectives

1. The Gulf Cooperation Council (GCC) member-states include the United Arab Emirates, Saudi Arabia, Qatar, Kuwait, Oman, and Bahrain
2. The countries form a trade bloc, which provides a common market, including coordination of customs regulations and various trade-related laws
3. The GCC is a regional intergovernmental political and economic union
4. The GCC Customs Union was launched in 2003, eliminating internal tariffs, enabling the free movement of labor and capital internally and creating a unified 5% external tariff on most imported products
5. GCC countries have signed free-trade agreements with Singapore and the European Free Trade Associations
6. The EU established bilateral relations with the GCC countries through the 1988 Cooperation Agreement, aimed at strengthening stability in a region of strategic importance

Why investors are attracted to the GCC

- ✓ Sizable and stable economic growth
- ✓ Sector liberalization and privatization
- ✓ Population growth
- ✓ Economic diversification
- ✓ Comparative industrial advantage
- ✓ Infrastructure investment
- ✓ Regulatory and economic restructuring
- ✓ Macroeconomic conditions
- ✓ Availability of capital
- ✓ Greater exit opportunities

Resetting the GCC economies

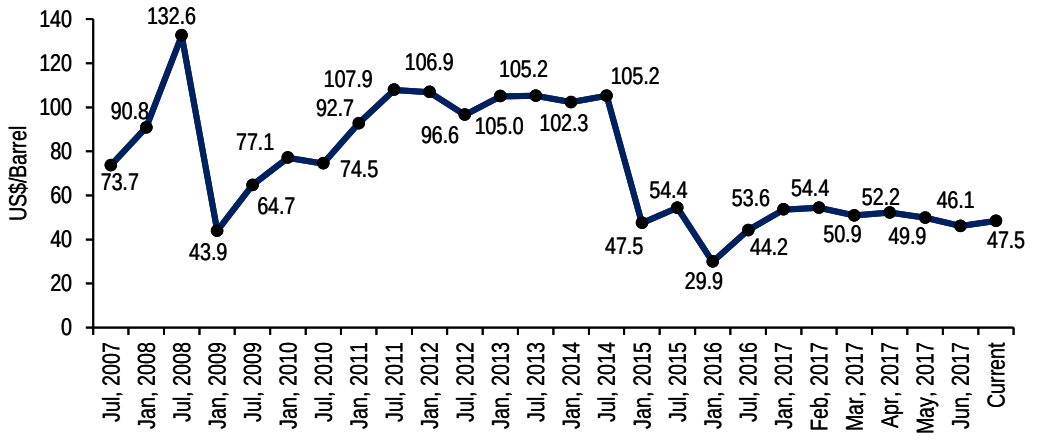
As you may be aware - the GCC member-states countries, which include the United Arab Emirates, Saudi Arabia, Qatar, Kuwait, Oman, and Bahrain - have for the past 2 years endured some challenges that have heavily impacted deal flow in the region.

Slumping oil prices have lowered government revenues and negatively affected spending plans. Therefore, in order to reduce their dependence on oil in the future, the GCC states have been pursuing unprecedented structural reform initiatives.

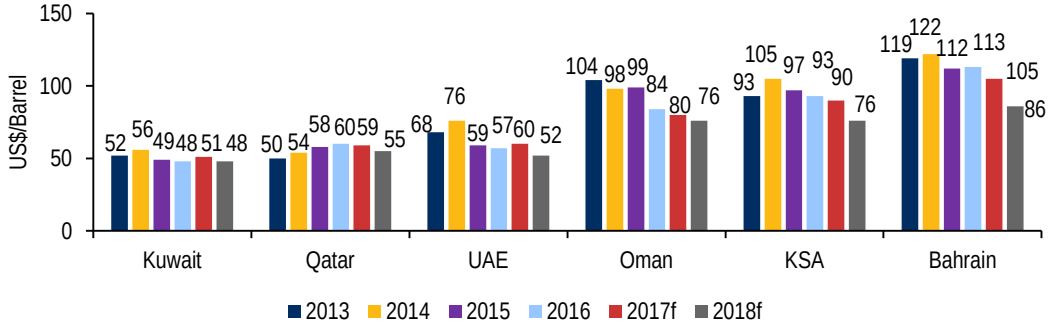
Falling oil price

Oil price trend over the last ten years

Source: World Bank Data

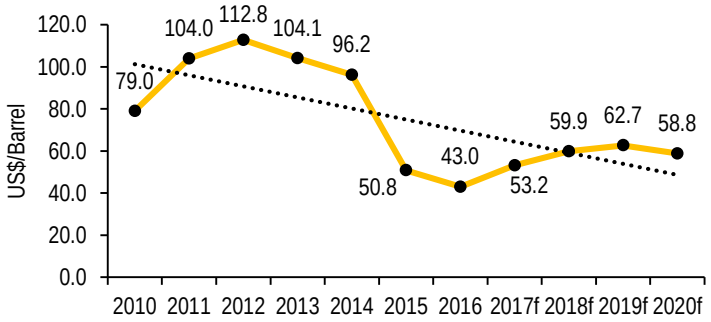


Source: Institute of International Finance (IIF).



- The GCC has traditionally been heavily reliant on oil.
- According to IMF, the near-term outlook for the GCC region has weakened, with growth forecast to be 2.6% in 2017, 0.8% point lower than projected in the October 2016 World Economic Outlook.
- Oil prices dipped from US$132.6 per barrel in 2008 to a record low of around US$29.9 per barrel in 2016 and are forecasted to be at an average of around US$60.5 per barrel in next three years.
- GCC countries have realized the need to diversify their sources of revenue and this is evident by the year-on-year dip observed in their budget breakeven oil prices (see chart below).

Source: World Bank Data



Impact of oil price decline in GCC economies

Oil price decline

Lower government revenue and economic growth

- The GCC region lost 20.0% of its combined GDP (US$ 340b) in 2015, owning to lower oil prices.
- GDP growth forecasts in the MENA region expected to drop to 2.3% in 2017 from 3.8% in 2016.

Reduced budget allocation or spending

- The Kingdom of Saudi Arabia (KSA) slashed its transport and infrastructure budget in 2016 by 63.0%.
- Oman experienced c.11.0% decline of overall spending and c.18.0% reduction of project investments in 2016.

Projects stalled or cancelled

- Qatar Petroleum and Shell have withdrawn from an Al Karaana petrochemicals project worth US$6.5b.
- Shell has pulled out from a Bab sour gas reservoirs development project (worth US$10b) with Abu Dhabi National Oil Company.
- Qatar has delayed development of Sharq Crossing program (worth US$12b).

- Slumping oil prices have severely affected the countries in the GCC region and have lowered government revenues which has negatively affected their spending plans.
- The recent budgets in Saudi Arabia, Qatar, Oman, and the UAE, for the first time in decades, saw major cutbacks in expenditure.
- Lowering oil prices also results in loss of confidence of foreign investors, impacting the overall FDI in the region.
- Currently, the market perception about growth in the GCC region is highly pessimistic and investors around the world believe certain serious reforms and revenue diversification measures need to be taken by countries in the region in order to restore market confidence and trigger growth.

Reforms in the GCC: Diversification of economies

GCC countries have announced plans to introduce an estimated 5.0% value added tax (VAT) in 2018, which has to be the most significant measure taken in order to counter the negative impact of crashing oil prices.

- **KSA** is building six new economic and industrial cities, a new 450-kilometer-long high-speed rail link between Makkah and Madinah, KSA's first large-scale tourist development in the South of Dammam and expanding Taif's historic Souk, all in order to achieve economic diversification.
- **KSA** is also considering offering full 100% foreign ownership for businesses in certain sectors like retail to attract foreign investors.

- **Oman** has approved a law which levies a 15.0% income tax on all corporations without exception.
- **Oman** has also amended its fee structure on a range of services such as the services offered by the administration in a bid to augment its non-oil income and increase revenue diversification.

Reforms in the GCC: Diversification of economies (continued)

- **UAE** has made major cutbacks in subsidies in the energy sector (petrol, natural gas, diesel, electricity, and water) in order to reduce pressure on state budget.
- In order to achieve diversification **UAE** has been increasing its expenditure in infrastructure development; Dubai is hosting the 2020 World Expo, Abu Dhabi is developing new urban districts including the iconic Cultural District, which will see the opening of three world-class museums.

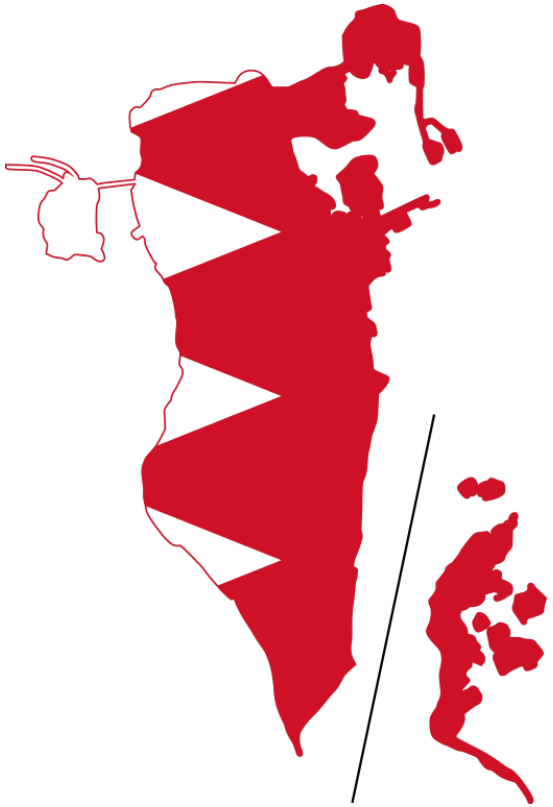
- **Kuwait** has hinted at the introduction of income, corporate, and sales taxes to shore up its finances.
- In order to achieve diversification and attract more tourists, **Kuwait** has been making large investments in its infrastructure and has unveiled a new plan to transform the country into a regional financial and cultural hub by 2035 through 164 strategic development programs. These include development of the City of Silk, KD 1 billion metro project and KD 8 billion rail project to link the six partners of GCC.

- Privatization of state run firms to increase revenue in mining, education, transportation, and healthcare sectors is a tactic used by **Qatar** to attract foreign investors.
- There has also been tremendous amount of expenditure in the development of infrastructure of the country in order to attract tourists and reduce dependence on oil. For example, **Qatar** is expected to award US$200b worth of large projects over the next 10 years, in part driven by preparations to host the 2022 FIFA World Cup.

GCC economic outlook

GCC economic outlook: 2017-2018 (Bahrain)

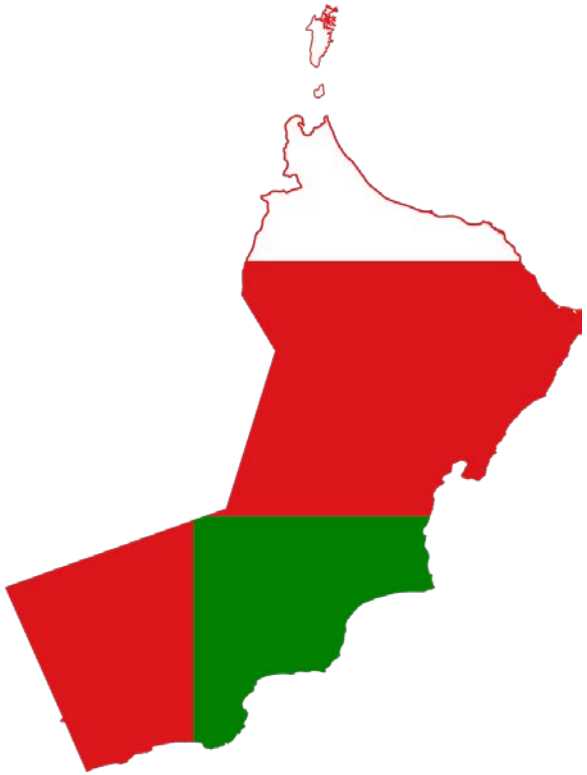
Real GDP growth projections have been revised downwards to 1.9% in 2017 and 2018, as continuing low oil prices depress private and government consumption. Average inflation is expected to decrease to 2.1% in 2017 reflecting the cooling off in economic activity.



Market Insight

- ✓ Bahrain is the only country in the region offering 100% foreign ownership of business assets and real estate in most sectors
- ✓ Foreign investment is the key to ‘Bahrain’s Economic Vision 2030’ - the long-term plan for improving the competitiveness of the economy, creating skilled jobs, and enhancing living standards
- ✓ Bahrain’s visa policies are among the most flexible in the region, providing easier and quicker access for businesses with operations in the country.
- ✓ Ranked the 18th most open economy worldwide by the Heritage Foundation and Wall Street Journal’s 2016 Index of Economic Freedom
- ✓ Comprises the region’s most liberal business environment, with zero taxation for private companies, few indirect taxes for private enterprises & individuals, and free repatriation of capital
- ✓ The workforce is the most educated and skilled in the Gulf which means minimized spending on expatriate packages & a long-term, sustainable local workforce (Bahrainis comprise 2/3 (65%) of the financial services workforce, according to the Central Bank of Bahrain)

GCC economic outlook: 2017-2018 (Oman)



Protracted low oil prices continue to weigh on Oman's economy. Fiscal and current account deficits remain large, and Oman is increasingly resorting to external borrowing to finance its deficits. Real GDP growth is estimated to have slowed down to 2.2% in 2016 from 5.7% in 2015, according to official Omani estimates.

Market Insight

- ✓ M&A and general commercial activity in Oman remains buoyant despite the low oil price environment
- ✓ Large-scale projects in the maritime sector, such as Port Sultan Qaboos Waterfront, could open the market for foreign investors to gain a foothold in a highly attractive market
- ✓ Tourism is set to be one of the key pillars for economic growth in Oman in the coming decades. It is estimated that by 2020 the number of hotel rooms in the country will be more than 20,000, giving a major boost to the country's ambitious tourism growth strategy that hopes to attract 5 million visitors a year by 2040
- ✓ An expressway project set for completion in 2017 and the game-changing Oman rail network will only increase interconnectivity between the Sultanate's ports and local and regional markets
- ✓ Oman's new port, Port of Duqm has the trappings of a world-class, multi-purpose commercial gateway and will propel Oman to be one of the top 10 logistics hubs in the world, doubling the contribution made by the logistics sector to Oman's GDP by 2020, studies show

GCC economic outlook: 2017-2018 (Saudi Arabia)

As hydrocarbons account for about 80% of fiscal revenues and more than 40% of GDP, the KSA remains vulnerable to subdued prices. However, because the 2017 fiscal budget moderately eases consolidation measures, the non-oil economy should recover as the pace of fiscal adjustment eases and grow by 2.1% in 2017. Overall, GDP growth is projected to be 0.6% in 2017.

Market Insight

- ✓ The Kingdom is a G20 member with the 3rd biggest current account surplus in the world (World Bank Data 2016)
- ✓ It is one of the fastest-growing countries worldwide, with per capita income forecast to rise from $25,000 in 2012 to $33,500 by 2020
- ✓ The private sector is playing an increasingly larger role in the economy, it now accounts for 39.5% of GDP and is expected to continue to grow, especially as RSA opens its doors further to foreign investment
- ✓ The largest economy and market in the GCC, 19th largest economy in the world, with a population of 30.7 million
- ✓ Investors are offered tax incentives for training and recruitment of Saudi labour
- ✓ 16th largest exporter and the world’s 29th largest importer in the world

GCC economic outlook: 2017-2018 (United Arab Emirates)

Major investments such as the Dubai Expo 2020 are expected to ramp up the economy and growth is expected to pick up in the medium term. Overall real GDP growth is estimated at 2.3% in 2016, a significant drop from the pre-2014 oil shock average of 5% (2010-14).

Market Insight

- ✓ A diverse, growing economy with investment incentives such as 0% corporate tax, 0% income tax, and up to 100% foreign ownership in free zones
- ✓ Politically and economically stable within the Middle East region located strategically between Europe, Africa, and Asia with over 1,000 flights weekly to most countries worldwide
- ✓ First class modern infrastructure which includes metros, trams, strong private local and international healthcare facilities
- ✓ Available sectors for safe and secure investments include the precious metal industry, general trading, hospitality sector, tourism industry, oil and gas, and obviously real estate
- ✓ Crime rate at an all-time low within all the emirates compared to most parts of the world

GCC economic outlook: 2017-2018 (Kuwait)

Kuwait's economy grew by an estimated 3% in 2016, supported by higher oil production and implementation of the Development Plan. GDP growth in 2016 accelerated to an estimated 3% (market prices) from 1.8% the previous year. Output in the non-oil sector expanded by an estimated 2%, better than in 2015 (1.3%) but less than half the pace before global energy prices began to fall in 2014.

Market Insight

- ✓ Kuwait is the GCC's only parliamentary democracy and remains relatively stable and prosperous. It retains significant oil reserves
- ✓ About 40% of its 2.5 million population, enjoy some of the highest disposable incomes
- ✓ Foreigners can apply for a license to own up to 100% of a Kuwait onshore legal entity under the new Direct Foreign Investment Law, in a plan to diversify the economy
- ✓ New finance & security techniques can be used e.g. allowing investors to assign government proceeds and assets to lenders and the pledging of shares prior to the two-year lockout period in order to provide security to lenders

Foreign Investment Insights

Foreign investment insights

Foreign investment rules in all GCC countries are intended to protect national entrepreneurs and to limit the circumstances in which foreigners are able to take full ownership of companies.

1. Foreign investors usually have two options:

- ✓ **Joint venture** – the investor identifies a local company which will contribute to the business, share any financial risk, and facilitate business development and operations on the ground; or

- ✓ **Arrangements with a local businessman (or company)** – a partner in name only; even where such a local partner owns majority of the company, the foreign investor will put in place side agreements which allow the foreign partner to retain almost all the profit, carry all the risk, and exercise full control over the business.

Foreign investment insights (continued)

2. The regional free zones are being increasingly perceived as stable jurisdictions with advantageous foreign ownership and compliance requirements.

3. Choosing a forum for disputes and a governing law can be one of the most critical elements to completing an M&A or JVA transaction. The Dubai International Financial Centre (DIFC) continues to be the dominant dispute resolution forum with DIFC/LCIA arbitrations (London Court of International Arbitration) continuing to become more established and known to the parties in this region.

4. English law remains the most popular governing law and is the preferred choice for most of M&A deals, and most of JV transactions.

Foreign investment insights (continued)

5. There is growing evidence of market maturity, as we continue to see a shift towards more sophisticated purchase price adjustment mechanisms, such as;

i) **completion accounts** – using a ‘net asset/ net debt’ adjustment, whereby a dollar for dollar adjustment is made if the actual ‘net asset/ net debt’ position of the target at completion is different to the estimated net asset/ net debt amount agreed on between the parties at signing.

ii) **locked box mechanism** – whereby the purchase price calculation is based on a balance sheet (taking into account both the company’s ‘net cash/net debt’ position and its working capital) at a date agreed between the buyer and the seller before entering into the share purchase agreement.

iii) **more extensive warranty protections** given on an indemnity basis, and

iv) **an increase in earn outs mechanism** – whereby the seller has a right to further payments if the target business performs sufficiently well after transaction consummation.

Foreign investment insights (continued)

6. Tax warranties and tax deeds

Historically, there has been a view that buyers do not need to insist on extensive protection against tax liabilities. In light of the imminent introduction of VAT in the GCC, this market practice is likely to change.

Corporate tax regimes do however exist and are becoming more established in certain parts of the GCC. Buyers should be careful before conceding too quickly when discussing protections against tax liabilities of the target. This is likely to be a more important issue with the implementation of VAT in the GCC, starting next year.

Foreign investment insights (continued)

7. Limitations on Liability – where sellers' limitations are included, they typically comprise time limits by which claims must be brought, the first threshold a buyer must reach before he can bring a claim for breach of warranty, and the overall cap limit on the quantum of such claims.

8. Restrictive covenants and confidentiality

The purpose of restrictive covenants in an M&A context is to protect the value of the business of the target for the buyer after completion, particularly as the seller may have intimate knowledge of the target business. Typical restrictive covenants in this context include:

i) Not to compete with the business of the target
ii) Not to solicit customers away from the target company
iii) Not to solicit employees/directors away from the target company, and
iv) To keep information about the target company confidential

Foreign investment insights (continued)

9. New commercial companies laws

In 2015, the UAE, Saudi Arabia, and Qatar adopted new commercial companies laws. Across the three jurisdictions, we can see various themes emerging such as more streamlined and flexible corporate set-up options, improved access to company information, more rigorous approach to corporate accounting, and greater emphasis on corporate governance and directors duties.

Earlier in 2012, a new commercial companies law was introduced in Kuwait, with further amendments in 2013, 2016, and 2017.

Still in Kuwait, the country's Capital Markets Authority (CMA) was established in 2010, and laws amended in 2014 and 2015. This has had severe regulatory and other ramifications to the corporate governance environment improving transparency, accountability, independence, etc.

Foreign investment insights (continued)

10. Competition laws

The UAE, Saudi Arabia, and Qatar each have a competition law regime in place. However, the regulatory regime in all three jurisdictions is in its relative infancy and there are few examples and limited publicly available information to illustrate how the regulators interpret the applicable laws and exercise the powers granted to them in practice.

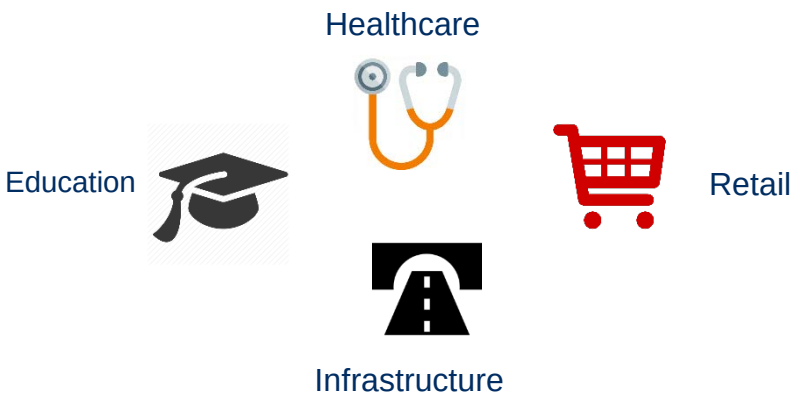
GCC industries attractive to investors

GCC industries attractive to investors

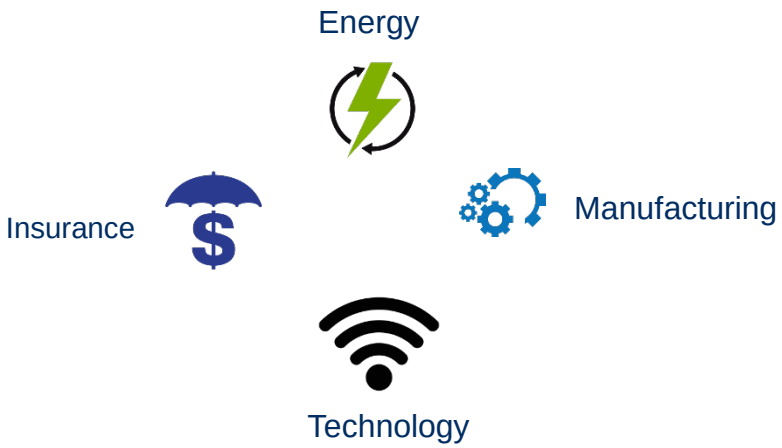
- Overall, the GCC market remains dynamic. The healthcare, education, and insurance sectors in particular attract plenty of interest both from within and from outside the region.

- There's cautious optimism in the market that this trend may continue and that up-and-coming sectors such as technology, may fuel an increase in deal activity in the near future.

M&A Top Sectors

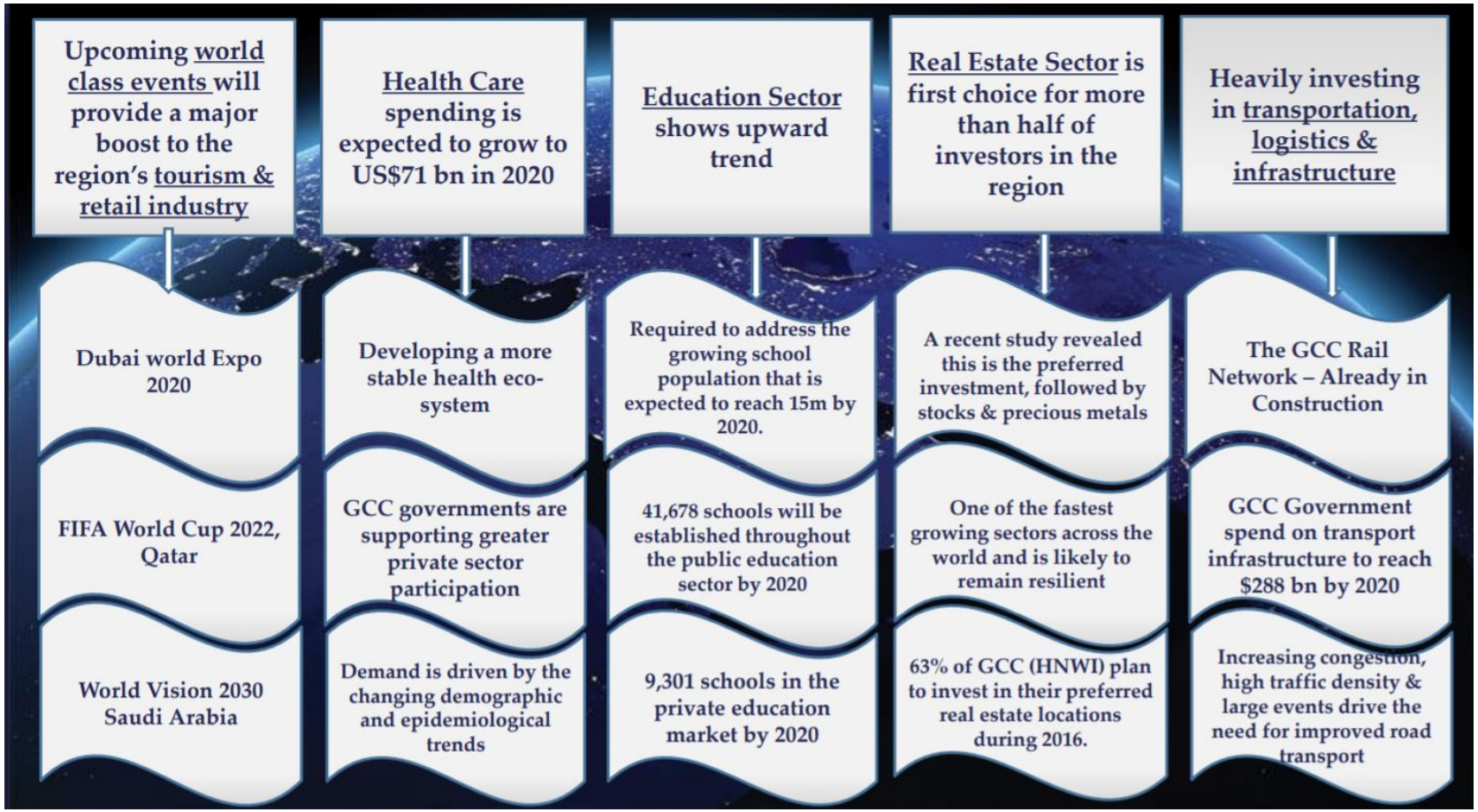


JV Top Sectors



GCC industries attractive to investors (continued)

Beyond oil, new revenue pathways in the growing range of non-oil goods and services areas are being sought, while, on the investment side, both the well-capitalized sovereign wealth funds and an increasing range of private investors are building up wide-ranging investment portfolios



Regional nuances

Cash is king – Most popular form of consideration: Most buyers are reportedly facing difficulty when issuing shares as non-cash consideration

Asset transfers – Difficult to complete in the GCC

Delayed completions – An increase in the period used for the Longstop Date

Restrictions – Limitations on foreign ownership of companies remain in some jurisdictions

Key events impacting deal-flow

1. Low oil prices and a strong dollar are putting pressure on GCC currencies, forcing the Gulf countries to continue with painful fiscal consolidation. But we expect the region to stick to its policy of pegging against the dollar – for now.

2. Last year's political shocks in two of the GCC's most important trading partners – Brexit in the UK and the election of Donald Trump as President in the USA – are expected to impact heavily on deal activities in this region.

3. This year, a further blow was felt after some GCC countries decided to isolate Qatar over allegations that Doha is supporting extremism.

4. The governments' commitment to host mega events, such as Expo 2020 Dubai, 2022 FIFA World Cup Qatar, and various initiatives of the GCC governments should boost the Real Estate, Hospitality & Construction sector.

M&A overview

M&A growth potential

As we move from 2017 to 2018, the main areas for potential growth in the GCC region that we expect to see are:

- A new flow of partial privatization sales that will start to rekindle equity capital markets
- Banks and corporations will look to consolidate and restructure
- Debt capital markets will remain busy, given continued fiscal deficits and demands for corporate refinancing, despite rising borrowing costs
- Private equity in the GCC will pick up as early stage venture-capital style deals with technology start-ups attract international as well as strong local interest, helping to increase M&A activity
- The Public Private Partnership project pipeline will expand into education, healthcare, and transport infrastructure, as new laws come into force and projects get underway

Sources: Bloomberg, Elite Economics

The first half of 2016 saw the GCC countries reaching $18.7 billion in regional M&A activity.

VAT’s impact on deal-making

Starting next year, the GCC countries will be rolling out VAT with the UAE and KSA doing so in January 2018. In the context of due diligence for M&A, IPOs, and Joint Venture transactions:

- Specialized tax and financial due diligence will be required and should now include a thorough look at VAT. This would include a review of documents relating to past compliance.
- Tax warranties, covenants, and indemnities should also be included to ensure that new shareholders are compensated for any existing tax liabilities and penalties.
- The use of holding companies and whether the transaction costs of the holding company (e.g., banking and finance as well as legal and advisory fees) are subject to VAT, VAT exempt or out of scope should be considered.
- The applicability of VAT groupings in the context of Joint Venture transactions should be considered.

Factors aiding M&A growth

Several important factors are facilitating M&A growth in the GCC region:

- Greater availability of distressed assets spurring M&A opportunities
- Structural changes in Saudi Arabia yielding to long-term M&A market potential
- Increased domestic bank consolidation in the GCC
- Sovereign wealth funds will keep fueling the M&A market
- Brexit is creating opportunities for acquisitions with long-term perspective

Sources:

Middle East Deal Study 2017 – Clyde & Co

GCC Economic Outlook – April 2017 – the World Bank

Bloomberg News

Investment Outlook 2017: Deal Trends in the GCC – Hogan Lovells

2017 Investment Outlook – Middle East Investor Relations Association

Investing in the GCC – Goodwins Law Corporation

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