

United Arab Emirates

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MARKET TRENDS AND ACTIVITY

1. Please describe briefly the private equity market in your jurisdiction, in particular:
 - The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.
 - Market trends (for example, the role of hedge funds in private equity).
 - Any proposed or pending regulatory changes.

Sources of funding

Private equity funds obtain their funding from banks, companies, pension funds, insurance companies and government institutions in both Dubai and Abu Dhabi. Funding is also obtained from sophisticated high net-worth individuals and wealthy local family businesses. Investors also include sovereign funds from the Gulf Cooperation Council (GCC) which includes countries such as Saudi Arabia and Kuwait.

Market trends

The economic downturn has led to a severe decline in the level of private equity activity in the UAE. It is common to see parties attempting to renegotiate or cancel proposed investments by citing the economic climate as a *force majeure* event. In these circumstances, it is possible to agree certain payment/investment terms to allow the investment to complete.

It is not usual for hedge funds to be involved in private equity transactions in the UAE.

Regulatory changes

The Dubai International Financial Centre Authority (DIFC) has recently made a series of regulatory changes to its collective investment funds regime to make the DIFC a more competitive financial hub, including for private equity funds.

A further regulatory change which may impact on investment in the UAE is the proposal to increase the permitted percentage of foreign ownership in UAE companies. Currently foreign companies can only invest up to 49% in UAE companies. It is proposed to increase the limit to between 70% and 100%. However, this change has been under discussion for several years now.

2. Please summarise any changes in the level of activity in recent years in relation to:
 - Fundraising by private equity funds and hedge funds.
 - Private equity investment in established, early stage and start-up businesses.
 - Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs), leveraged buyouts and public to private transactions).
 - Exits by private equity funds (that is, the realisations of the investments).

Fundraising

As a result of the global financial crisis, fundraising by private equity funds has diminished, as investors are typically being more cautious.

Investment

Again as a result of the global financial crisis, the level of private equity investment has decreased in recent years. Before considering new investments, private equity funds are generally focusing on the investments made before the economic downturn to assess their likely returns.

Transactions

The number of transactions has also decreased dramatically. The economic climate has resulted in investors requesting more thorough due diligence on target companies, and therefore transactions are generally taking significantly longer to complete. Investment committee approval of transactions is also taking longer, adding to delays in transactions.

Management buyouts and management buy-ins are not common.

Exits

There are fewer exits taking place and, where possible, private equity funds are trying to hold their investment with a view to obtaining a better return in the long term. Exits that are taking place usually experience poor returns as a result of the high valuations that were agreed before the economic downturn.

There are also more distressed sales in the market.

TAX AND STRUCTURING

3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

With the exception of foreign banks and oil producing companies, no income tax is imposed on businesses in the UAE.

The DIFC, created in 2004, has a mandate to remain tax free for 50 years. This mandate is renewable for an additional 50-year period.

4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

DIFC

The three types of corporate entities that can be used to establish a domestic fund in the DIFC are:

- Investment companies.
- Investment trusts.
- Investment partnerships.

Trust structures are predominantly used for property funds, and investment partnerships are commonly used for private equity funds. An investment partnership is a limited partnership registered with the DIFC, comprised of a general partner and limited partners. The general partner must be authorised by the Dubai Financial Services Authority (DFSA) to act as the fund manager.

The two types of funds that can be established in the DIFC are:

- Public funds.
- Exempt funds.

As public funds are open to retail investors, more extensive regulatory requirements apply to these funds to protect such investors. Exempt funds are only open to professional clients (*see Question 9*) who must make a minimum subscription of US\$50,000 (as at 1 November 2010, US\$1 was about EURO.7). Exempt funds can only have 100 or fewer unitholders and cannot be offered to the public (distribution is only allowed through private placement). Private equity funds are usually exempt funds.

Outside the DIFC

Outside the DIFC, a company cannot issue different classes of shares (*Commercial Companies Law*). This restricts the ability of private equity funds to create suitable entities. Therefore, a foreign registered entity (such as a company registered in the Cayman Islands or the British Virgin Islands (BVI)) is usually used instead. These foreign entities must be registered in accordance with the Central Bank Resolution No. 164/8/94 relating to the Regulation for Investment Companies and Banking, Financial and Investment Consultation Establishments or Companies (Central Bank Resolution).

5. For each structure identified in *Question 4*, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- So far as domestic investors are concerned.
- So far as foreign investors are concerned.

Currently there are no taxes imposed on the structures discussed in *Question 4* in the UAE or DIFC.

6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

Not applicable (*see Question 5*).

LICENSING AND REGULATION

7. Are a private equity fund's promoter, principals and manager required to be licensed?

To establish and manage a fund with the DIFC a DFSA licence is required. To obtain the licence, the applicant must demonstrate the following to the DFSA:

- There are adequate systems and controls to manage the type of fund that it is proposed to establish.
- The individuals performing certain functions within the company (for example, the board members and senior management) meet the relevant suitability and integrity criteria.

Once a licence has been granted, the DFSA supervises the fund manager's activities on an ongoing basis.

If the applicant intends to establish and manage only exempt funds (*see Question 4, DIFC*) there is a fast-track process that involves self-certification relating to the adequacy of systems and controls. However, the DFSA still supervises these fund managers on an ongoing basis.

8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

In the DIFC, private equity funds usually take the form of exempt funds (*see Question 4, DIFC*). The fund manager of an exempt fund is not required to keep the fund property with an eligible custodian. The fund manager must instead:

- Appoint an investment committee for the fund.
- Make certain disclosures in its prospectus relating to the method of holding the fund's assets.

The marketing of funds is based on generally accepted principles of disclosure through prospectus requirements. The level of prospectus disclosure required for public funds (which are open to retail investors) is higher than for exempt funds (which are open to professional investors only).

The Central Bank Resolution requires that investment funds be licensed. However, there is a list of exempted entities that do not require a licence.

9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

Private equity funds in the DIFC tend to be exempt funds and, as such, are only open to professional clients. In the DIFC, a professional client is a person that:

- Has net assets of at least US\$500,000, or is an employee of an authorised firm associated with the fund or holds a professional position in another authorised firm.
- Appears, on reasonable grounds, to the authorised firm, to have sufficient experience and understanding of the relevant financial markets, products or transactions and any associated risks.
- Has not elected to be treated as a retail client.

The DFSA can impose any additional restrictions on any fund that it regulates.

In addition, unless a private equity fund is a UAE fund, it cannot take a majority shareholding in a limited liability company in the UAE. The nationality of the beneficial owners of the fund is disregarded for this purpose.

10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

As the majority of the funds are Cayman Island or BVI entities, the relationship between the fund and its investors is governed by the applicable foreign law.

11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

In the DIFC, professional clients must make a minimum subscription of US\$50,000 to participate in an exempt fund.

In addition, for a licence to be granted to an investment entity (see *Question 4*), the paid up share capital of the company should not be less than AED1 million (as at 1 November 2010, US\$1 was about AED3.6) (*Central Bank Resolution*).

INVESTMENT OBJECTIVES

12. What are the most common investment objectives of private equity funds?

The average life of a fund is between three to five years. The average rates of return sought are over 20%.

INTERESTS IN PORTFOLIO COMPANIES

13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

In the UAE, private equity funds commonly take equity in a portfolio company. It is not common for private equity funds to provide debt funding. However, Islamic banks commonly invest through equity and financing. Conventional banks are not permitted to take equity.

The advantage of taking equity in a portfolio company is the ability to obtain the maximum return on the investment as a result of an exit. The disadvantage of taking equity is the financial loss if the portfolio company goes into liquidation.

The advantage of debt funding (particularly the so-called emergency funding) is the ability to negotiate a high rate of interest on the debt. In addition, the debt will rank in the event of liquidation and it is possible to secure the debt with the company's assets.

In a limited liability company, there are statutory pre-emption rights which must be respected on a transfer of shares.

BUYOUTS

14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

It is uncommon in the UAE for buyouts of private companies to take place by auction.

15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Buyouts of listed companies are uncommon.

16. What are the principal documents produced in a buyout?

The principal documents produced in a buyout are the:

- Acquisition documents for the target company.

- Investment documents regulating the relationship between the management and the private equity investor (including the shareholders' agreement to regulate the relationship among the shareholders and the memorandum and articles of association of the target company).
- Documents relating to the debt facilities (if any).

17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

Private equity funds normally seek protection through warranties in relation to various aspects of the target company's business. In addition, covenants regarding the following matters are usually provided:

- Future revenue or net profits of the target company.
- Recoverability of receivables.
- Continued employment of key employees.
- Key customer and supplier contracts.

Information about the management team can be requested and indemnities are sought if there are particular areas of concern.

18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

There are general obligations under UAE law in relation to privacy and the divulging of trade secrets as well as the obligation of confidentiality and the duty to avoid causing harm. A portfolio manager must comply with these laws when approaching potential investors.

19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

The terms of employment typically imposed on management involve comprehensive restrictive covenants. It is also usual for management to be obliged to transfer any shares that they hold in a target company on termination of their employment. The value received for the shares usually depends on the circumstances under which the manager's employment has ended.

In addition to this, employee share options and "golden hand-cuffs" can be included.

20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?

The private equity fund can have a right to appoint director(s) to the board of the portfolio company, and in the UAE it is common for private equity funds to appoint a director to the board. Private

equity funds can also be given veto rights where their votes do not control the board. These protections are normally found in the shareholders' agreement.

DEBT FINANCING

21. What percentage of finance is typically provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

In the UAE, debt financing by private equity funds is uncommon. Investment is usually made through equity investments. However, Islamic banking institutions commonly provide debt and equity funding (see *Question 13*). The debt financing is usually in the form of loans or convertible loans. These transactions are structured to ensure compliance with Sharia law.

22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- Security?
 - Contractual and structural mechanisms (for example, covenants or subordination)?
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Security

Debt providers commonly take a mortgage over the borrower's real estate. Assignment of receivables and commercial mortgages can also be entered into.

Contractual and structural mechanisms

Covenants can be obtained from the company to prevent it taking any further debt which ranks before that of the lender. Alternatively, taking any new debt can be made subject to the existing lender's consent.

23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

In the UAE, there are no rules preventing a company from providing financial assistance.

24. What is the order of priority on insolvent liquidation? Are certain debt providers given priority over other debt providers? Are debt providers given priority over other stakeholders by law or is priority purely a matter of contract and company constitution?

The order of priority on an insolvent liquidation is as follows:

- Government debts.
- Payments to employees.
- Secured debts.

- Unsecured debts.
- Payments to shareholders.

In a limited liability company, after the return of equity any excess is paid to shareholders in proportion to their right to receive dividends.

25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

Investment can be provided through convertible loan notes where the investor has the option to convert the debt into equity at a certain price (not less than the nominal value of the shares). This mechanism can be used by an investor to achieve more upside.

PORTFOLIO COMPANY MANAGEMENT

26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Management incentives are commonly granted through the issue of shares or a higher participation in the company's profits. Employee share option schemes can also be implemented.

27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

At the present time there are no taxes imposed in Dubai, the UAE or the DIFC on portfolio managers.

EXIT

28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buyout)? What are the relative advantages and disadvantages of each?

An exit can be by way of an IPO but more usually it takes the form of a secondary buyout. An IPO usually produces a better return

than a secondary buyout. However, an IPO is more dependent on market conditions and is, therefore, not always viable.

29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

It is usual for a private equity fund to invoke a put option in the event of an unsuccessful investment. The private equity investor will normally have the ability to invoke the put option if certain financial thresholds concerning the company's revenue or net profits have not been met.

Deferred payment clauses are also possible. This mechanism is used to reduce the purchase price of the shares, or avoid making further investment where the company is not achieving certain financial milestones.

CONTRIBUTOR DETAILS



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Areas of practice. Private equity; banking and financial services; project finance; Islamic banking; sukuks (Islamic equivalent of bonds); treasury products; acquisitions and divestitures.

Recent transactions

- Acting on behalf of Dubai Investments in relation to the sale of its interest in Metrofile Middle East LLC.
- Acting on behalf of Awwal Fitness Limited in relation to sale of the Fitness First business in the Middle East.



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