Private equity in the United Arab Emirates: market and regulatory overview

Ziyad Hadi, Danielle Lobo and Silvia Pretorius
Afridi & Angell Legal Consultants

global.practicallaw.com/6-500-6174

MARKET OVERVIEW

1. How do private equity funds typically obtain their funding?

Private equity funds obtain their funding from:

- Banks, companies, pension funds, insurance companies and government institutions in Dubai and Abu Dhabi.
- Sophisticated high net-worth individuals and wealthy local family businesses.

Investors also include sovereign funds from the Gulf Cooperation Council (GCC), that includes countries such as Saudi Arabia and Kuwait.

2. What are the current major trends in the private equity market?

The private equity market has continued to show signs of recovery with an increase in the number of investments. However, the fundraising environment has remained relatively challenging.

Private equity firms in the region have continued to favour the non-cyclical sectors including healthcare and education. Sectors such as real estate, construction and financial services continue to see low levels of activity (although there has been a marked increase in activity over the past year). As a result of the "Arab Spring", a number of countries including the UAE continue to be popular destinations for investment. This is as a result of these countries being perceived as "safe havens". The UAE has attracted a large share of this capital due to its political stability and its status as an international business centre.

3. What has been the level of private equity activity in recent years?

Fundraising

The ongoing global macroeconomic challenges, driven primarily by the continuing uncertainty in Europe, have resulted in a difficult fundraising environment. The reduced level of fundraising may also result from the increased focus on managing, preserving and enhancing value in current portfolios that have been held during the financial crisis.

Investment

Despite the continuing economic challenges, investments in the region have increased in recent years. However, despite the increase in liquidity in the region, investment levels are yet to recover to 2007 to 2008 levels. In addition, the initial public offering (IPO) market is relatively stagnant and therefore private equity remains a key funding option for companies seeking fresh capital.

Transactions

There has been an increase in growth capital, venture capital and small and medium enterprise (SME) investments in recent years. These investments are typically low value minority interest investments. Since the financial crisis, there has been a continued absence of large buyout transactions.

Exits

The number of exits in recent years has increased as a result of the convergence of the buyer-seller valuation gap. The higher levels of free cash and also the availability of debt financing have also increased the number of successful exits.

An increased number of exits have also resulted from fund managers holding a backlog of portfolio companies during the economic downturn. The need to achieve value maximisation on exits is crucial to fund managers who are seeking to demonstrate a positive track record in order to seek commitment for new fundraisings.

REFORM

4. What recent reforms or proposals for reform affect private equity in your jurisdiction?

In 2012, the UAE Securities and Commodities Authority (SCA) introduced SCA Board Resolution No. 37 of 2012 on the Regulation of Investment Funds (as amended) (Regulation of Investment Funds). The Regulation of Investment Funds significantly affects the:

- Marketing of interests in investment funds established outside the UAE ("foreign fund").
- Establishment of local investment funds domiciled onshore in the UAE ("local fund").

In summary, the key changes in the Regulation of Investment Funds include:

- The transfer of primary responsibility for the general oversight of investment funds in the UAE from the UAE Central Bank (Central Bank) to the SCA.
- SCA approval must be obtained to market a foreign fund to investors in the UAE, although there are certain limited exceptions. The exceptions to obtaining SCA approval for the marketing of a Foreign Fund in the UAE were introduced by the SCA Board Resolution No. 13 of 2013. This provides that the

Regulation of Investment Funds does not apply to the promotion of units of foreign funds:

- directed at financial portfolios owned by federal or local government entities (for example, sovereign wealth funds);
- to companies, corporations or authorities whose primary purpose (or one of its primary purposes) is to invest in securities (provided that the foreign fund markets to those entities and not to the clients of those entities); and
- to investment managers, provided that the investment manager has the authority to make and implement investment decisions.

- The SCA also confirmed the position on "reverse enquiries": the issue of units in a foreign fund as a result of enquiries initiated by a UAE-based investor will fall outside the scope of the Regulation of Investment Funds.
- SCA approval must also be obtained for the establishment of a local fund.
- In general, a locally licensed placement agent must be appointed to be able to market a foreign fund in the UAE.

TAX INCENTIVE SCHEMES

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

The following legislation is currently in force in the Emirates of Dubai and Abu Dhabi:

- Abu Dhabi Income Tax Decree 1965 (as amended).
- Dubai Income Tax Decree 1969 (as amended).

However, the regime is not enforced, apart from in respect of companies active in the hydrocarbon industry and branches of foreign banks operating in the wider UAE.

Within the Emirate of Dubai there is a free zone known as the Dubai International Financial Centre (DIFC). Activities conducted in or from the DIFC are subject to regulation and supervision by the Dubai Financial Services Authority (DFSA). The DIFC also has its own legal, regulatory and court system. There is a zero rate of personal and corporate tax in the DIFC for a period of 50 years from the date of establishment of the DIFC (*Dubai Law No. 9 of 2004*). This period can be extended for a further 50 years (*Law No. 9 of 2004*). The other free zones in the UAE also have 50 year tax free periods.

FUND STRUCTURING

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

Outside of the DIFC

Very few funds are domiciled in the wider UAE. One of the reasons for this is the lack of suitable fund structures. All corporate entities (except branches of foreign companies and corporate entities incorporated in the free zones) must be majority owned by one or more UAE nationals or entities owned by UAE nationals.

The types of entity that can be used to form a local fund are not specified. However, the Regulation of Investment Funds appears to envisage a local fund being established by contract between the investment manager and the investors. While contractually based funds are common in the GCC, they exist in many other jurisdictions as an alternative to establishing a fund as a separate vehicle.

DIFC

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

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

Trust structures are predominately 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 general partners and limited partners. The general partner must be authorised by the DFSA to act as the fund manager.

The two types of fund that can be established in the DIFC are public funds and exempt funds.

As public funds are open to retail investors, more extensive regulatory requirements apply to these funds. Exempt funds are only open to professional clients who must make a minimum subscription of US$50,000. Exempt funds can have no more than 100 investors and cannot be offered to the public (distribution is only allowed through private placement). Private equity funds are usually exempt funds.

7. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

At present, there are no taxes imposed on the structures discussed in *Question 6*.

8. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax transparent or otherwise)? What alternative structures are typically used in these circumstances?

This is not applicable (*see Question 5*).

INVESTMENT OBJECTIVES

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

The average life of a fund is between three to five years, with average rates of return sought being over 20%. In line with previous years, private equity funds continue to be cautious and it is thought that the focus will remain on investment in non-cyclical and defensive sectors such as healthcare, retail and education.

FUND REGULATION AND LICENSING

10. Do a private equity fund's promoter, principals and manager require licences?

Outside the DIFC

The Regulation of Investment Funds imposes the requirement for a foreign fund to engage a "local promoter" in relation to the offering of a foreign fund in the UAE (*see Question 4*). The Regulation of

Investment Funds provides that the following entities can be licensed as a local placement agent in respect of a foreign fund:

- A bank licensed by the Central Bank.
- An investment company licensed by the Central Bank.
- A company holding an SCA licence to act as a local placement agent.
- A representative office of a foreign company (in the case of private offerings to "institutions" where there is a minimum commitment of AED10 million per subscriber).

With respect to a local fund, the Regulation of Investment Funds prescribes that the company establishing the local fund must appoint a board of directors comprising three, five or seven directors. In the event of a vacancy on the board of directors, a replacement director cannot be appointed without the SCA's approval. It is also not possible to remove a director without the SCA's prior approval.

DIFC

To establish and manage a fund in the DIFC, a DFSA licence is required. To obtain the licence, the applicant must demonstrate that both:

- There are adequate systems and controls to manage the type of fund that it proposes to establish.
- The individuals performing certain functions within the company (for example, 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 only intends to establish and manage exempt funds, there is a fast track process that involves self-certification relating to the adequacy of the systems and controls. However, the DFSA still supervises these fund managers on an ongoing basis.

11. 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 6*). 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).

Foreign funds can only be marketed in or from the DIFC by DFSA licensed firms holding advisory or arranging authorisations. A foreign fund must meet the eligibility criteria set by the DFSA.

12. Are there any restrictions on investors in private equity funds?

Outside of the DIFC

A foreign fund that is not open to the public in its home jurisdiction must be promoted to "pre-determined" potential investors (*Regulation of Investment Funds*). The Regulation of Investment Funds does not define what is meant by the term "pre-determined".

DIFC

Private equity funds in the DIFC tend to be exempt funds and therefore are only open to professional clients. A professional client is a person that meets all of the following criteria:

- Has net assets of at least US$500,000, 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.

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

Outside of the DIFC

Where a foreign fund is not open to the public in its home jurisdiction, the minimum subscription amount per investor is AED500,000, except in the case of a foreign fund established in a free zone outside the UAE (*Regulation of Investment Funds*). In the latter case, the minimum subscription amount per subscriber is AED1 million.

DIFC

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

INVESTOR PROTECTION

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

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

INTERESTS IN PORTFOLIO COMPANIES

15. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Most common form

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.

In the UAE, as in most other jurisdictions, 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 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.

Other forms

Taking equity in a portfolio company is generally the most commonly used form of instrument. Other forms of instrument, such as convertible and exchangeable ones, are generally not used.

Restrictions

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

Foreign companies can only invest up to 49% in UAE limited liability companies (outside the free zones).

Taxes

There are no taxes imposed on the structures discussed above in the UAE or DIFC (*see Question 5*).

BUYOUTS

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

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

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

Buyouts of listed companies are uncommon.

Principal documentation

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

The principal documents produced in a buyout are:

- Equity documents:
  - investment agreement;
  - articles of association;
  - employment agreements.
- Acquisition documents:
  - share purchase or asset purchase agreement;
  - disclosure letter.
- Finance documents (if any):
  - bank facility agreement;
  - bank security documents.

Buyer protection

19. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

Private equity funds usually 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.

The private equity shareholder will also have veto rights with respect to certain key decisions of the portfolio company.

20. What non-contractual duties do the portfolio company managers owe and to whom?

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.

21. 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 include 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 handcuffs" can be included.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

The private equity fund can have a right to appoint directors to the board of the portfolio company, and this is common. Private equity funds can also be given veto rights where their votes do not control the board. These protections are usually found in the shareholders' agreement.

DEBT FINANCING

23. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

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 15*). The debt financing is usually in the form of loans or convertible loans. These transactions are structured to ensure compliance with Sharia law.

Lender protection

24. What forms of protection do debt providers typically use to protect their investments?

Security

Debt providers commonly take a mortgage over the borrower's real estate. Assignment of receivables and commercial mortgages can also be entered into. A commercial mortgage is a registrable form of security over the business premises, which includes all tangible and intangible assets of the company. Perfection of the commercial mortgage is by way of registration in the commercial register of the relevant Emirate in the UAE.

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.

Financial assistance

25. 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?

Outside of the DIFC

There are no rules preventing a company from giving financial assistance for a purchase of shares in the company. However, the current draft of the new UAE Commercial Companies Law provides that joint stock companies cannot provide financial assistance to any shareholder to enable them to acquire shares in the company. In addition, the draft law does not provide for a statutory "whitewash" regime as seen in other jurisdictions.

DIFC

A company cannot provide financial assistance for a person to acquire shares in the company or a holding company of the company unless the financial assistance falls within certain exemptions provided for in the Companies Law (*Article 46, Companies Law (DIFC Law 2 of 2009)*).

Insolvent liquidation

26. What is the order of priority on insolvent liquidation?

Outside of the DIFC

On a company's insolvent liquidation, priority is granted to certain preferred claims including the payment of:

- Wages and salaries due to employees for the 30-day period before the declaration of insolvency.
- Government taxes for the two years before the judgment of insolvency.
- Rent due on business premises for the current and previous year.
- The costs and expenses of the insolvency proceedings.

Payment will then be made to secured creditors and lastly to unsecured creditors.

DIFC

The DIFC Preferential Creditor Regulations apply to any company to which the DIFC Insolvency Law (DIFC Law No. 7 of 2004) applies. Together, the Insolvency Law and the Preferential Creditor Regulations provide that on the winding up of a company, its preferential debts must be paid after the expenses of the winding up, in priority to all other debts whether secured or unsecured. The following are deemed to be preferential debts:

- Sums owed by the company in connection with an employee's pension or an end of service gratuity payment.
- Remuneration of a company's employees for up to four months preceding the date of the appointment of a provisional liquidator or the winding up order in the case of a compulsory winding up.
- Any payments due in lieu of notice.
- Compensation in respect of accrued holiday entitlement.

Equity appreciation

27. Can a debt holder 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). An investor can use this mechanism to achieve more upside.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used 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.

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

At present there are no taxes imposed in the UAE on portfolio managers investing in their company (*see Question 5*).

30. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

In a limited liability company, there is a statutory requirement to set aside 10% of its net profit each year for the formation of a statutory reserve. Accumulation of this reserve can be suspended if it reaches half the capital. The shareholders can agree to form other reserves if desired. Dividends can only be paid from the distributable profits of the company.

31. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

There is a statutory requirement that the directors in a portfolio company must be liable to the company, the shareholders and third parties for all:

- Acts of fraud or abuse of power.
- Violations of the law or of the bye-laws.
- Errors in management.

The UAE authorities have recently taken firm steps towards addressing corrupt practices in the private sector. Many individuals who have engaged in corrupt conduct have been subject to investigation and prosecution in recent years.

EXIT STRATEGIES

32. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

Corporate divesture by way of a sale to a trade purchaser or an asset sale are the most common and most effective forms of exit strategy.

Advantages and disadvantages

In a corporate divestiture, the seller usually has more flexibility around the negotiation of the purchase price. This can be due to the fact that the trade purchaser is looking to make a strategic acquisition, to expand into a new market or offer a new product or service to its customers that compliments their current offering. Another advantage of a corporate divestiture is having multiple potential purchasers involved in a bidding war or formal auction process for the portfolio company.

A disadvantage of a corporate divestiture is that it can take up significant management time and nearly always takes longer than expected, even for smaller companies.

33. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed 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 can usually invoke the put option if certain financial thresholds concerning the company's revenue or net profits have not been met. On a practical level, specific performance (or any other equitable remedy) is at the discretion of a UAE court and, in general, equitable remedies are not available in cases where an award of damages is considered to be an adequate remedy.

Deferred payment clauses are also possible. The mechanism is used to reduce the investment cost or to avoid making further investment where the portfolio company is not achieving certain financial milestones.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

MENA Private Equity Association

Status. The MENA Private Equity Association is a non-governmental organisation established in the DIFC.

Membership. Membership is by invitation only for active private equity and venture capital firms in the Middle East and North Africa (MENA) region that meet set criteria, for example:

- Private equity firms with over US$100 million of funds under management in the MENA.
- Venture capital firms with over US$20 million of funds under management in the MENA.

Principal activities. The MENA Private Equity Association is a non-profit entity committed to supporting and developing the private equity and venture capital industry in the MENA region. The association aims to:

- Foster greater communication within the region's private equity and venture capital network.
- Facilitate knowledge sharing to encourage overall economic growth.

The association also develops statistics to enhance transparency.

Published guidelines. Annual Reports on Private Equity & Venture Capital in the MENA region.

Information sources. Private Equity and Venture Capital reports and roundtable discussion papers.

ONLINE RESOURCES

Securities and Commodities Authority (SCA)

W www.sca.gov.ae

Description. This is the website of the Emirates Securities and Commodities Authority (SCA). The website contains SCA rules and regulations. In the event of any inconsistency between the Arabic and the English text of the rules and regulations, the Arabic will prevail. The website is generally up to date.

Dubai Financial Services Authority (DFSA)

W www.dfsa.ae

Description. This is the website of the Dubai Financial Services Authority (DFSA). It contains the legislation, consultation papers and policy statements of the DFSA. It also has a public register containing information on firms and individuals registered with the DFSA. The website is generally up to date.

W www.difc.ae

Description. This is the website of the Dubai International Financial Centre (DIFC). It contains DIFC legislation and regulations. These laws are drafted in English. The DIFC website also contains a directory of the companies incorporated in the DIFC. The website is generally up to date.

Practical Law Contributor profiles

Ziyad Hadi, Partner

Afridi & Angell
T +971 4 330 3900
F +971 4 330 3800
E zhadi@afridi-angell.com
W www.afridi-angell.com

Professional qualifications. Pakistan Bar Association

Areas of practice. Corporate and commercial; mergers and acquisitions; real estate.

Danielle Lobo, Senior Associate

Afridi & Angell
T +971 4 330 3900
F +971 4 330 3800
E dlobo@afridi-angell.com
W www.afridi-angell.com

Professional qualifications. Law Society of Scotland

Areas of practice. Corporate and commercial; mergers and acquisitions; private equity.

Silvia Pretorius, Senior Associate

Afridi & Angell
T +971 4 330 3900
F +971 4 330 3800
E spretorius@afridi-angell.com
W www.afridi-angell.com

Professional qualifications. Member of Side Bar (Natal and Transvaal Provincial Divisions), South Africa

Areas of practice. Corporate and commercial; infrastructure; project finance; banking and finance.