GCC Private Equity: Where to Next?

November 2024

GCC Private Equity: A Maturing Ecosystem

Whereas private equity has had a long (if sometimes controversial) history in Europe and particularly the US, its development in the GCC is both more recent and more gradual. With the first regional private equity funds only forming in the 2000s, by the 2008 Global Financial Crisis there was only an estimated $1bn in GCC private equity, out of a worldwide total of approximately $2.3 trillion. It is only really since 2019-2020, despite and arguably because of the impact of Covid, that the GCC private equity ecosystem has seen its profile rise compared to its peers in the US and Europe, and as a result has seen accelerating growth.

Over the last few years, higher economic growth in the region compared to the US or Europe, regulatory changes, an increased maturity and sophistication in GCC private equity's offer to investors, and an influx of multinational GPs has seen a step change in the GCC ecosystem. From $1bn AUM in 2008, estimates for current GCC private equity AUM are now $12bn-$15bn, with over 100 active GPs in the region including international firms.

Transaction data in the GCC remains scarce, but this is now viewed as an advantage for private equity firms able to source and structure proprietary transactions, rather than a source of frustration. Nevertheless, S&P Global Market Intelligence data points to $11.6bn of private equity and venture capital investments in the Middle East for 2024, down 26% from $15.7bn in 2022. This is a similar level of annual decline as for private equity globally, with the same drivers: the rise in interest rates and fewer large volume transactions. Of note is that within this transaction volumes, MAGNiTT estimates approximately $2.7bn in venture capital funding in the Middle East in 2023, focused on the KSA and UAE – this again reflects a similar weighting to venture capital as seen in the US, and again reflects the depth of innovation in the region.

GCC Private Equity Ecosystem

$1Bn AUM in 2008

$12-15Bn AUM in 2024

In terms of focus sectors, it is interesting that despite the high profile infrastructure, energy and constructions projects at present, S&P estimate that some 60% of 2023 Middle East private equity investment volume was in technology, telecoms and financials, speaking to the diversification and growth prospects of GCC economies. Furthermore, MAGNiTT data shows that almost half of 2023 Middle East venture capital funding was in fintech, emphasizing the region's opportunity in the intersection of these economic sectors. Nevertheless, a key driver of investment opportunities that cuts across a number of sectors, as elsewhere in the world, is the continued growth in business outsourcing.

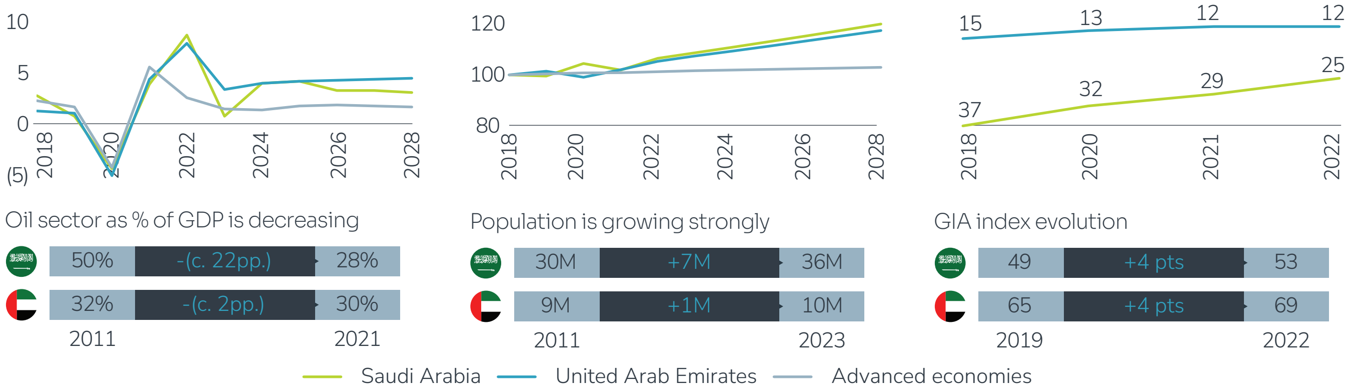
The GCC region has experienced a significant transformation in its private equity landscape over the past few years. Several key factors have contributed to this evolution:

- **Robust Economic Growth & Market Attractiveness:** Strong macro tailwinds underpinned by accelerating secular drivers and increasing market attractiveness has provided a fertile ground for private equity investments. Factors such as economic diversification, a growing workforce and an improving business-friendly environment (as measured by the Global Attractiveness Index) make the GCC region a compelling investment environment.

Economic Growth and Diversification
GDP growth in pp. per annum, 2018-2028

Growing Workforce
Indexed to 100 in 2018, 2018-2028

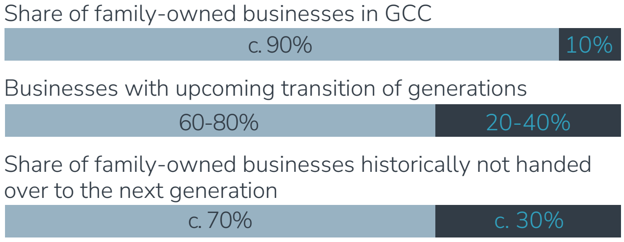
Market Attractiveness
GIA ranking, 2019-2022



Source: GIA; IMF; World Bank; UAE MoF

- **Favorable Regulatory Environment:** Governments in the GCC have implemented various regulatory reforms to streamline investment processes and create a more conducive environment for private equity. These reforms have made it easier for both local and international investors to participate in the market.
- **Increasing number of targets:** The GCC has a high concentration of family-owned businesses, many of which are undergoing generational transitions. This presents a significant opportunity for private equity firms to acquire businesses as family owners seek to exit or raise capital.

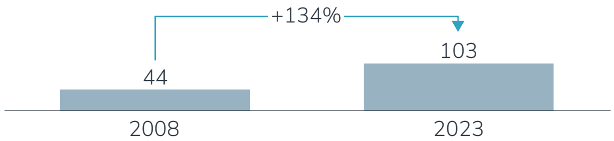
Successions drive opportunities to acquire businesses



Mergermarket; Preqin; Gulf Cooperation Council; Market Reports; Company websites

- **Influx of Multinational GPs and Maturity of Ecosystem:** The GCC private equity ecosystem has experienced significant growth and professionalization in recent years. The number of active private equity GPs has increased by 134% since 2008, reaching 103 in 2023. Additionally, several large international GPs, such as Blackrock, CVC Capital Partners, Ardian, and Brookfield, have established offices in the GCC within the last two years. This growth and professionalization have unlocked easier financing from banks and created additional exit opportunities for other PE players.

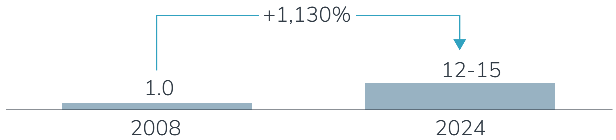
GCC PE ecosystem is strongly growing and professionalizing
Number of Private Equity GPs active[1] in GCC



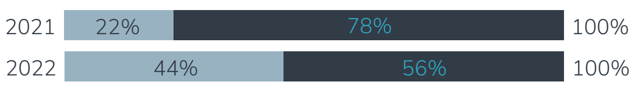
Exemplary large international GPs opening an office in GCC within the last two years

Growth and professionalization of the PE environment is unlocking easier financing from banks and bringing additional exit opportunities to other PE players

Increasing demand for Private Equity in the GCC region
GCC Private Equity AUM[2] ($B)



Increasing allocation of regional SWF to Alternatives



Professionalizing ecosystem provides for attractive growth momentum and liquidity in the market

[1]Manager who has raised a fund in the last 10 years
[2]Refers to amount of AUM reported by AAM coming from privately owned GCC businesses
Source: Mergermarket; Preqin; Gulf Cooperation Council; Market Reports; Company websites

These factors have collectively led to a step change in the GCC private equity ecosystem, making it a more attractive destination for both local and international investors.

Outsourcing: A Key Trend Driving PE Growth

In our previous report, "Essential Business Services: A Private Equity Strategy Positioned for Downside Protection and Growth", we set out the global dynamic of companies looking to further outsource non-core activities to reduce their cost base and increase profitability, driven by a combination of increasing regulation, reshaping of supply chains and a higher cost of capital.

In particular, we focused on outsourcing within 'essential business services', which in our view is not a specific segment of the economy as such, but rather a range of businesses that share key characteristics, and which can be considered the indispensable plumbing of an economy. In this framework, the key characteristics of these businesses are as follows:

- Their clients are businesses or governments, not consumers;
- They perform critical functions for businesses
- The functions may range from basic to high value add, but are non-discretionary – they need to be performed come what may;
- Revenue is typically based on contracts, not transactions;
- The businesses are cash generative;
- They are often asset light services;
- The sectors are often fragmented, but bigger clients seek bigger providers.

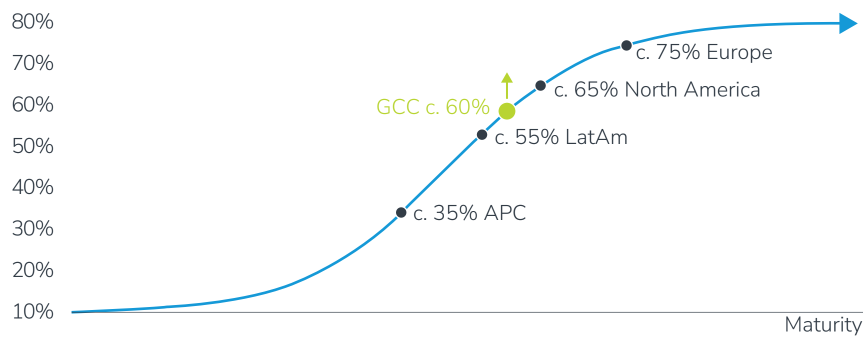
Here, we look specifically at the GCC landscape for this sector: the prevalence of outsourcing in the region compared to the US and Europe; the nature of outsourcing in the GCC, governed by its wider economic dynamics; our view on essential business services in the region within the private equity ecosystem; and importantly the nature of investments in this sector.

How Widespread Is Outsourcing Compared to the US or Europe?

According to a study by ISG, a leading global technology research and advisory firm, the level of outsourcing in the GCC is some respects not far behind the US, although some way behind Europe. Europe leads globally in terms of outsourcing penetration with some countries such as France and the UK being mature markets and reaching levels of 80%+, driven by higher labor costs and a highly regulated business environment. In turn, North America's lower penetration can be seen as a reflection of relatively lower labor costs and a more variable regulatory environment, though with a more active private equity involvement in the sector.

Within this global context, the GCC is viewed as a region with c. 60% outsourcing, a tier below the US but in the highest acceleration segment of the S-curve, reflecting a rapidly growing market with ample possibilities.

Indicative Outsourcing penetration rate by region %



Source: ISG, a leading global technology research and advisory firm

What Is The Nature Of Outsourcing In The GCC?

What is perhaps the greatest differentiator of the outsourcing dynamic in the GCC is not the overall market penetration though, but the nature of the outsourcing given its more recent development and the specific needs of its companies. In our view, there are three main differences.

1 In-Region Focus with High-Value Outsourcing

Firstly, in previous cycles outsourcing from the US or Europe has had a focus on shifting lower margin tasks to lower cost labor markets – for example IT services to India, or customer engagement to Eastern Europe. However today's acceleration in GCC outsourcing takes place in a time of widespread digitization, but also geopolitical focus as to where sensitive tasks are undertaken. As a result, GCC outsourcing is tending towards in-region providers, leveraging sophisticated tech solutions and international best practice in systems and processes, rather than multinationals based on an overseas low cost, largely manual offer. This keeps the intellectual property in the region, aiding in the general diversification of the GCC economies, and also enables outsourcing and optimization of higher value processes, contributing to a balanced growth in the same economies.

2 Sector-Specific Outsourcing Aligned with Regional Needs

Secondly, the types of outsourcing in the GCC speak to the overall needs of the region, and how these differ from the US or Europe. Most obviously, the greater importance of infrastructure, logistics and real estate development at present means that right now demand for design and construction services in engineering, architecture and mechanical/electrical systems is relatively higher in the GCC, although we may well be at the peak of this demand. Conversely, facilities management for completed infrastructure and recently developed buildings is smaller in relative terms, but is already a large sector and with attractive growth prospects as current projects complete. Perhaps less obviously, IT services are less about maintaining or transforming legacy systems (as is fairly common in the US and Europe) and more about designing and operating fully modernized platforms that capitalize on widespread digitization. Equally, differences in the regulatory environment and labor markets compared to say the US, lead to greater regional priorities in services such as verification of inbound labor or automation of white collar tasks.

3 Generational Shift Towards Efficiency and Flexibility

Finally, in contrast with more mature markets such as Western Europe, in the GCC many industries are undergoing a generational shift, with second and third generations of business owners focused on increasing margins and maximizing operating efficiencies. This leads to comprehensive discussions on outsourcing non-core services with a view to implementing best-in-class company structures, without the legacy constraints that may be encountered in Europe for example. At the same time, the range of businesses looking to outsource is often wide and the specific company requirements are more variable, so a traditional multinational model focused on large scale enterprise clients is often less suited to the GCC landscape than a more flexible, regionally focused approach that can deliver a range of tailored services to differing customers.

Essential Business Services In The GCC

Given these regional characteristics, how does our general global interpretation of essential business services, as set out at the start of this report, translate into our view of essential business services within the GCC private equity ecosystem?

In short, we see five key sectors as representing the greatest opportunity in essential business services in the region:

Business process outsourcing | IT services | Engineering services | Facilities management | Logistics and supply chain

Within our framework, these five sectors encapsulate the current and future dynamics that are specific to the GCC:

- Current infrastructure, renewable energy and real estate development requires **engineering services** for design and construction, but more importantly in the medium and long term, for ongoing inspection and certification – this covers for example HVAC, lifts and electrical systems in buildings, cooling systems in temperature controlled warehouses, solar arrays and electrical transmission lines, but also structural integrity of bridges or regulatory compliance. This is particularly the case for KSA but the opportunity is across the GCC;
- As projects complete, the requirement for **facilities management** to operate them continues to increase – this covers for example the maintenance of the buildings and systems set out above, and services ranging from security and fire protection, through to catering and landscaping;

- As transport infrastructure continues to expand and mature, urban growth remains steady, and technology advances, the requirements and possibilities for **logistics** in the GCC will continue to evolve and favor outsourcing to specialist providers. In addition, **supply chain** reorganization in light of geopolitical factors and to diversify the region's internal economies brings additional tailwinds;
- A powerful combination of widespread digitization in the GCC, the increasing complexity of IT systems, cybersecurity concerns and regulatory focus also favors businesses outsourcing **IT services** to specialists, but also enables these specialists to create cutting edge platforms less constrained by legacy systems. In turn, these cutting edge platforms can take advantage of new markets created by the very same tech-enabled opportunities in engineering services, facilities management and logistics;

- In a sense parallel to these sectors driven by the region's economic growth, there is the foundational sector of business process outsourcing that is driven by the region's economic maturation. Again enabled by the ability to implement next generation tech platforms, driven by new regulation, and supported by new generations of business leaders looking to maximize companies' efficiency, in the GCC outsourcing of **business processes** tends to focus on automation and value add (rather than low cost labor intensity as in previous cycles in the US or Europe). This is especially true for processes such as payments (for example, handling of accounts payable or receivable, processing of card or online payments, payroll management), tax management and compliance, recruitment and verification, and customer management.

These five sectors also fit well in terms of the key characteristics that for us identify a subsector as being an essential business service:

1. Their clients are all businesses or governments, not consumers;
2. The outsourced functions are critical to current and future operations;
3. Some functions are relatively basic but driven by the possibilities of modern tech can be increasingly value add (and therefore increasingly profitable);
4. Revenue is based on contracts, not transactions;
5. These businesses are cash generative, and capex and asset light; and
6. These sectors are often fragmented, although consolidation is underway in some countries. Bigger clients seek bigger providers, but the greatest opportunity is likely in offering a range of solutions to a diverse customer base.

Investing in GCC Essential Business Services

As much as the nature of outsourcing in the GCC may be different to the US or Europe, so too are the opportunities for investors, given the dynamics of the GCC private equity landscape we highlighted earlier. Globally, business services are estimated to have accounted for over 20% of private equity transactions over the last decade, making it an established sector with widespread investor attention and structured sales processes. In the GCC by contrast, the data on business services transactions to date has been limited. However we observe that this is now starting to change in line with the maturation of the GCC private equity ecosystem, with larger transactions in this space commanding the attention of multinational investors and increasing financing appetite widening the investor base for such larger deals.

At the same time, most deal sourcing remains proprietary and based on local networks and market understanding. An estimated 90% of GCC companies are privately owned, with anywhere between 60% and 80% seeing an upcoming transfer between generations – naturally most companies will remain in their current ownership, but the sheer scale of this generational transfer, the variety of firms and sectors involved, and the sometimes differing outlook of the incoming generations mean that the opportunities for investors to participate in this next phase of GCC economic growth should increase meaningfully going forward. The nature of these opportunities also means that they are unlikely to materialize as structured sales processes with defined parameters – in our view the more typical transaction will be a bilateral discussion, looking to provide a tailored solution to existing owners (in much the same way that we see the opportunity in GCC outsourcing as providing tailored offerings to a varied customer base, rather than a replica of commoditized products from the US or Europe).

Arcapita's Focus

In the GCC as elsewhere, market dynamics have created an environment that is driving outsourcing of essential business services, the (perhaps unglamorous) indispensable plumbing of the economy, where we appreciate the combination of their defensive positioning and sustainable returns driven by contractual cashflow. At the same time, the growing maturity of the GCC private equity landscape offers investors more opportunities to access this attractive sector.

Furthermore, in Arcapita's view, these dynamics provide a particular opportunity within GCC essential business services at present: sourcing proprietary, off market transactions within our target sectors that give tailored solutions to existing owners; leveraging the opportunity in new tech platforms to widen the companies' offerings, provide more value add services, and deliver flexible products to a more diverse customer base; and growing the company via both organic and inorganic growth in a consolidating market to a scale that attracts a comprehensive range of international investors and financers, to optimize the exit to the company's next owners.

This opportunity is not one of passive investment in the expectation of a rising economic tide and multiple expansion. Instead, it involves both know how and diligent application, from sourcing to crafting the transaction to fit all parties, to hands on implementation of business plans and strategic support – speaking to our philosophy that the most favorable investments are those that require active management and a targeted approach.

Importantly, we are able to identify a consistent pipeline of GCC opportunities matching these characteristics, that underlines our confidence in this investment focus. We believe the current environment offers an opportune time for investors to gain exposure to such investments, that will benefit from a highly favourable combination of strong, contractual income, and business growth through active management and operational improvements. We have conviction that this strategy presents the most compelling private equity investment opportunity in the GCC over the coming years.

Payment Processing

NEOPAY

In September 2024, Arcapita joined with Dgpays, a leading financial infrastructure technology firm, to acquire a majority stake in NEOPAY, the UAE's fastest growing payment solutions provider. This acquisition underlines the opportunity we see in business process outsourcing, in this case payment processing, and also the potential in outsourcing to IT and tech specialists creating cutting edge platforms. We are excited by the opportunity for NEOPAY to further accelerate its growth and expand its services, in line with the dynamics we are focusing on in the GCC.

Credential Verification

DATAFLOW

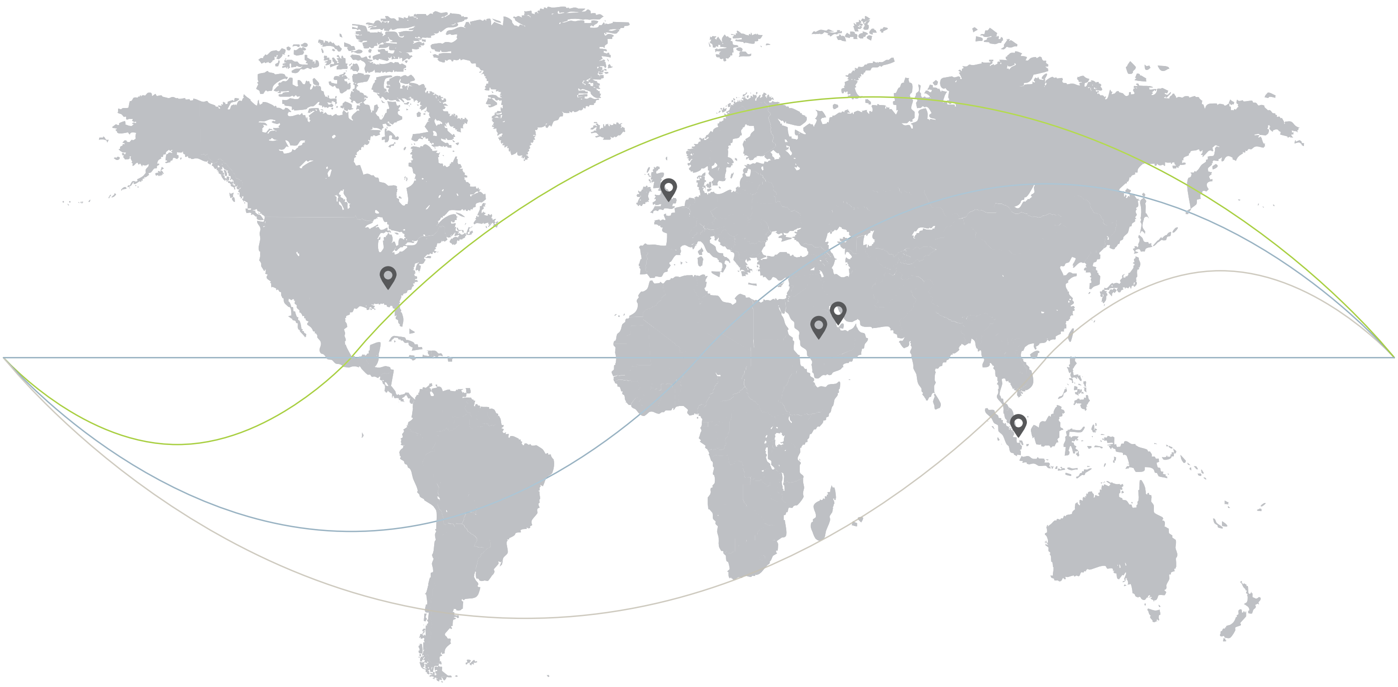
In September 2023, Arcapita acquired The Dataflow Group, the GCC's leading provider of pre-employment credential verification services. These verifications are mandated by regulation, and this transaction demonstrates our focus on the outsourcing of critical functions, for businesses or governments, as well as targeting sectors with strong growth tailwinds.

ARCAPITA

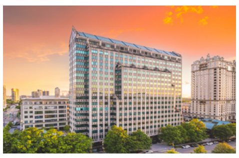
Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, and Singapore, Arcapita's management team has completed transactions worth a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



United States



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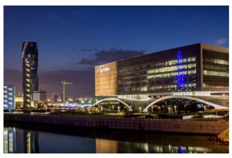

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