II.1. VENTURE CAPITAL DEVELOPMENT IN MENA COUNTRIES TAKING ADVANTAGE OF THE CURRENT OPPORTUNITY

II.1.1 WHY IS PRIVATE EQUITY & VENTURE CAPITAL PROMISING FOR ENTERPRISES IN THE MENA REGION?

National, regional and international competitiveness of an economy is increasingly connected to the presence of an environment supportive of innovation and risk-taking. Innovation is gaining prominence on agendas of governments throughout the world who increasingly appreciate the need to develop knowledge-based economies as a prerequisite to competitiveness and growth. Given this recognition, it should be of little surprise that policy design to support innovation in the private sector has become a hotly debated issue in both OECD and MENA countries alike. A consensus that public policy has a role in facilitating entrepreneurial activity seems to have emerged. Since a key barrier to entrepreneurship is a lack of capital to formalise creative ideas into concrete and realistic business plans, public sector involvement to bridge the financing gap can be useful.

Bridging of the financing gap can of course take various forms. Given the particular confluence of economic trends in the MENA region as well as the state of the financing industry, governments might be well advised to consider supporting private equity (PE) and venture capital (VC) schemes in order to facilitate entrepreneurship, and finally to encourage innovation. As the following Policy Brief argues, this may assist them in diversifying their economies, reducing unemployment, and contributing to the overall prosperity of their economies.

Many economies in the MENA region are currently in the process of privatising state owned assets, opening new sectors for foreign investment, and streamlining corporate taxation requirements. To this end, MENA governments are collaborating with international partners, including the MENA-OECD Investment Programme. By engaging in these reform efforts, MENA governments are unlocking the potential role for PE finance.

This is rapidly being reflected in the growth of the PE industry in the region. According to Zawya PE Monitor, $5.8 billion of private equity funds were raised in MENA between 1994 and 2005, 41% of which were raised in 2005 alone. The rapid growth of the PE industry reflects the potential of this method of finance in the region, in part due to the imperfect match between traditional equity/debt instruments and financing needs of MENA entrepreneurs. The relevance of VC development in the MENA region is particularly underscored by the following opportunities, as well as challenges.

A. Key Challenges

Addressing Unemployment

While it is difficult to speak of general causes of unemployment for MENA as a whole, it would be fair to say that in many countries, the current restructuring of the public sector precludes absorption of the currently unemployed. It is clear that solutions to increase private sector activity are a substantial part of the solution to address the significant unemployment gap in the region. Schemes to foster entrepreneurship can be promising from the standpoint of reducing unemployment in the region and improving its growth prospects. In essence, such schemes would entail equipping new labour

entrants with necessary business skills and linking them with sources of capital. A promising avenue to link entrepreneurs with capital is through VC financing.

In particular, public policy involvement in fostering a VC industry has proven to have positive employment consequences in other regions. Prior European experience certainly substantiates the important role of VC financing in encouraging entrepreneurship and reducing unemployment. For instance, between 1991 and 1995, net employment in European venture capital-backed companies increased by 15% annually, whereas net employment in 500 most profitable non-venture capital-backed European companies increased by 2% annually in the same period. Likewise, in the US, employment by venture capital-backed companies increased by 25% on average every year during the period 1989-1993, while employment by non-venture capital backed Fortune 500 companies dropped by a yearly average of 3% in the same time period.[1]

Limited Economic Diversification

Despite recent successes, economic diversification remains a key issue for almost all MENA economies, as manifested by continued high economic dependence on oil, agriculture, and other primary sectors. Low economic diversification in MENA countries is related to the fact that policy has been weak in fostering the development of strategic, knowledge intensive sectors where world exports are growing most rapidly.

Further development of PE/VC industry seems highly relevant to the diversification efforts of MENA economies. Research indicates that unlike traditional financing methods, VC is much more amenable to higher risk undertakings, particularly in technology intensive industries, which implies that VC development could indirectly assist MENA governments to diversify their economies. Additionally, if a high technology industry was to develop in the MENA region, it might be successful in attracting foreign private equity as well.

Difficulty obtaining financing

Another impetus for supporting VC schemes in the region is highlighted by the fact that financing can be difficult to obtain, particularly for emerging companies. Despite the fact that MENA entrepreneurs' external financing needs may also be lower than those in Europe or the US (generally 500-5000 euros)[2], many MENA businessmen and businesswomen may not be in a position to obtain it.

Access to both debt and equity financing has traditionally been a challenge. On a scale of 1-10, 10 indicating that collateral and bankruptcy laws are better designed to expand access to credit, the MENA region has scored 4.1, ahead only of the Latin America and the Caribbean.[3] In 2005, the figures on banking intermediation also draw attention to the fact that domestic credit to private sector is insufficient. In general, banking intermediation ranges from 49% in Egypt to 73% in Lebanon, but is still substantially lagging when compared to the comparable EU statistic (105% for EU15).[4]

Some regional governments have already reacted to this assessment. Countries such as Morocco, Israel, Jordan, Egypt, Tunisia and Lebanon have introduced public guarantee instruments in cooperation with domestic banking institutions in order to meet borrowing requirements of young firms. These efforts, although commendable, are not sufficient to meet the entrepreneurship financing needs in the region. Furthermore, entrepreneurial start-ups are generally not well-suited to the traditional forms of debt finance since they require funding for a period during which they are not generating revenues to cover expenses.

B. Key Opportunities

Ample Liquidity in the Region

On the positive side, the opportunity for further development of the PE/VC industry is underscored by the presence of substantial liquidity in the region. Over the past three years, the region entered a period of increased financial liquidity unparalleled since the petrodollar boom of the 1970s. This period is likely to last several years, due to a number of factors, including the rise in oil prices, repatriated funds since the end of 2001, and less attractive investment opportunities on global stock markets relative to the technology boom of the mid-1990s.

A conflation of these factors has resulted in an increased the combined backflow and retention of Arab capital in Arab economies, contributing to stock market capitalisation growth rates averaging over 200 percent for the 2002-2004 period, and reaching 400 percent in some countries. In 2005, the Shuaa capital index - an index of 12 Arab bourses - has gained over 91%, in addition to an almost 160% gain between January 2003 and December 2004.[5]

An additional factor which makes MENA especially amenable to VC finance is that the region possesses a number of high net worth individuals. Current estimates suggest that the private wealth of the Gulf alone stands at $1 trillion USD, and the Gulf Investment House estimates this figure to further rise to $1.5 trillion USD by 2007. MENA's high net worth individuals could provide a base for VC finance, thereby acting as a 'substitute' for institutional investors or bank finance, which dominate the VC industry in the US and Europe, respectively.

Foreign Venture Capital Seeking Potential Investments

The presence of high net worth individuals in the region is not the only potential source for private equity funding in the region. A recent Deloitte survey titled "Venture Capital Goes Global" highlighted that PE firms based in Europe and the US are seeking opportunities to invest abroad. In particular, US VC firms are still leading when it comes to global investment, with half of the VC firms expecting to invest abroad by 2010.[6] Moreover, foreign VC firms surveyed by Deloitte demonstrated an interest in investing in VC funds themselves (i.e. funds of funds), which provides an additional opportunity in that foreign VC could be interested in investing in MENA funds. A recent survey by the EMPA also highlights the interest of foreign PE in emerging markets – 64% of its survey's respondents were looking to increase their commitments there over the next 5 years.[7] These findings are especially important for the MENA region since foreign VC can act as a substitute for domestic investment in countries where domestic investors such as institutional investors or business angels are not well established.

Congruency between Islamic Finance and PE

The recent growth of Islamic finance in the region presents an additional opportunity for the development of local PE industry. This is related to the fact that the prohibition of interest is a central tenet of Islamic financing, the two primary alternatives being deferred trading-based debt finance and equity finance. Since risk capital at its base rests on equity participation, it is well suited to Islamic models of finance. Early indicators of the fact that the industry has recognised this congruency can be seen from the success of Bahrain-based *Venture Capital Bank*, launched in 2005. VC Bank is the first Sharia-compliant VC bank in the region, focusing on investment in SMEs and using a rigorous compliance system to ensure Shariah certification for investments. The growth and success of the VC Bank model has proven to be quite remarkable. In March 2006, VCBank has linked up with a well-established American venture capital firm, Global Emerging Markets Group (GEM Group), and the Saudi Arabian General Investment Authority (SAGIA), to establish a $100 million Saudi VC Fund to provide growth capital and late stage venture capital financing for SMEs in Saudi Arabia.

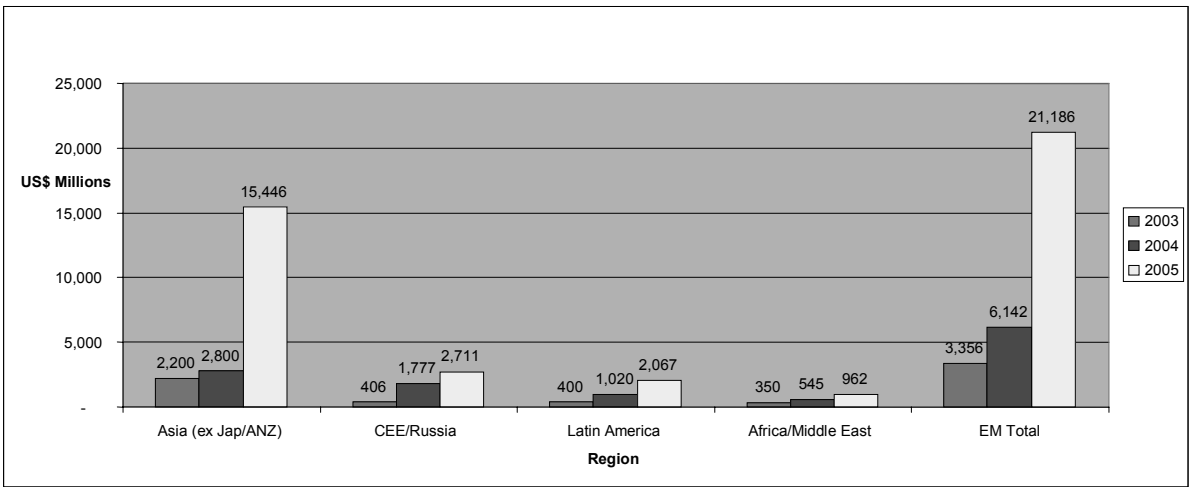
II.1.2 WHAT ARE THE IMPLICATIONS OF GLOBAL TRENDS ON VENTURE CAPITAL DEVELOPMENT IN THE REGION?

The particular opportunity for developing VC finance industry in the MENA region is underscored by increased global PE/VC flows not only in developed economies, but also to developing country regions. In this context, it is important to note that while venture capital activity seems to have increased, it has not risen as rapidly as did private equity activity.

A. Global trends point to an upturn in the PE market

Key publications on PE/VC performance point to a consensus that the PE/VC industry is on the rebound since 2004, following the bust of the high tech bubble. For the first time since 2001, an increase in VC activity is evident in both developed and emerging market economies alike. The Ernst and Young report on global private equity calls the year 2004 a "beginning of a new venture capital cycle". In the United States, Europe and Israel an aggregate of $25.7 billion USD was invested in over 3000 deals.[8] In emerging markets, a substantial increase in private equity investment can be noted as well (Figure 1).

Figure 1. Emerging Markets Private Equity Fundraising, 2003-2005



Source: EMPEA, 2005.

B. Performance Reflects Global Trends

Reliable statistics on the size and composition of PE industry in the region are difficult to obtain, in part due to the lack of a generally agreed upon definition of what constitutes PE/VC, in part due to a lack of a regional organisation similar to the European Venture Capital Association or the National Venture Capital Association in the US. According to Zawya's PE Monitor, $5.8 billion USD of private equity funds were raised in the MENA region between 1994 and 2005, of which $2.4 billion (41%)

were raised in 2005.[9] The industry grew at an approximately 40 CAGR over the past 5 years, increasing its rate of growth significantly since 2002.[10]

An interesting observation is that equity funds in the region have actually been oversubscribed. This is a significant departure from two or three years ago, when it was rather difficult to raise $100 million for a private equity fund.[11] However, it is important to note that most of the 16 funds that completed their fundraising in 2005 were promoted by established players, including Abraaj Capital, Ithmar Capital and the Global Investment House. Many of these established players are GCC based and are targeting opportunities in North Africa in tourism and real estate sectors.

Another notable trend is that the growth of the PE industry has not been equally distributed, with most investment in the Gulf region and Egypt. Recent analyses suggest that changes are also evident in the destination of funds raised by country and the sectors towards which these funds have flown. Prior to 2005, PE was predominantly focused on the opportunities in Egypt and the Levant. Today, the GCC countries have raised their profile quite substantially, particularly with the evolution of large players such as the GCC Energy Fund with an estimated value of $300 million USD.

In terms of capital raised specifically by VC funds, the increase from 2004 to 2005 was more modest, from $545 million to $962 million, which nonetheless represents a 77% increase.[12] While the growth in PE and VC financing conveys a positive outlook for the region, specific trends are difficult to ascertain due to data availability and fragmentation problems. For instance, while figures on the total VC capital raised are available, reliable figures on the capital invested - a more relevant measure of VC industry development – are not generally available. This observation underscores an overall lack of transparency of the funds operating in the region, which makes an informed assessment of regional trends in PE/VC challenging.

C. MENA PE Industry Is a Growing, But Nascent Industry

The general problem of data availability highlights that the PE industry in the region is still at an early stage of development, despite its recent growth. Unlike its US or European counterparts, MENA countries have yet to develop strong national venture capital markets or PE/VC associations at national and/or regional level. In Europe and the US, venture capital activities have been organised through umbrella organisations at both national and regional levels (The European Venture Capital Association and the National Venture Capital Association, respectively), which has not been the case in MENA until 2006.

Box 1. Gulf Venture Capital Association (GVCA)

The key mission of GVCA is to disseminate VC know-how and best practices in the region. The GVCA will do so through organisation of conferences, industry-focused technology forums, and workshops where members can share experiences. Although the emergence of GVCA represents a positive development for the industry, the extent to which it will be able to involve MENA countries outside the Gulf region in its activities, remains to be seen. The particular challenge with which GVCA will have to grapple is the diversity of financing requirements and the differences in states of development of the VC industries in the region

Source: GVCA, 2006.

MENA countries do not have a strong connection to the Emerging Markets Private Equity Association (EMPEA), which was launched in 2004 to serve the interests of private and venture equity, connecting all developing country regions. A key development in this regard, has been the establishment of the *Gulf Venture Capital Association* (GVCA), formed by a consortium of prominent institutions and professionals from across the Gulf Co-operation Council (GCC) countries "committed to supporting the growth of a strong venture capital and private equity industry within the Arabian Gulf."[13]

Another association promoting the role of financing and raising standards for operation of PE funds in the region is the *Arab Private Equity Association* (APEA). The APEA encourages cooperation between members by encouraging the exchange of information and experience between its members and bringing industry concerns to the attention of government and private investors. The Association also organises training on technical financial and legal aspects of direct investment and venture capital, as well as acts as a representative of the MENA PE industry in global agreements, adherence to which is an important precondition for development of VC. For instance, the APEA has endorsed the *Venture Capital Valuation Guidelines*, launched in 2005 in association with the Association Française des Investisseurs en Capital (AFIC), the British Venture Capital Association (BVCA) and the European Private Equity and Venture Capital Association (EVCA).

II.1.3. POLICY RECOMMENDATIONS TO FOSTER VC DEVELOPMENT IN THE REGION

A. Encourage Investment in Family Owned Enterprises (FOE)

The economic landscape in the region is largely dominated by relatively small family-owned enterprises (FOEs). While specific figures on the contribution of such enterprises to GDP are unavailable, it is known that SMEs in the MENA region account for 99% of companies and 2/3 of jobs, making a significant contribution to national GDP.[14] It is reported that in the GCC bloc alone, 5000 family businesses with assets of $500,000 million USD account for 75% of the private sector.[15] These figures highlight the importance of FOEs to the overall performance of MENA economies. As a result of their large contribution to MENA economies, local governments must take into account the needs of FOEs when formulating economic policy.

In particular, the regulatory framework in MENA must attempt to address numerous challenges specific to these enterprises to allow them to expand and become competitive globally. FOEs in the region are facing a number of challenges, including declining government protection, rapid change in technology, inadequate corporate governance practice, informal management structure and preference of ownership over growth.

Lack of adequate finance is at the top of the list of their challenges. Since few FOE can go public, PE financing may be an appropriate solution for them. Research conducted on FOEs which partnered with private equity houses in Europe demonstrates that 2/3 of those companies outperformed their competition, increased their exposure to new markets by over 60% and recorded an almost 50% increase in employment.[16] VC firms may be interested in buying out FOEs so as to restructure their capital, introduce incentives for management, identify additional acquisitions, and sell them at a substantial profit.

The MENA-OECD Taskforce on Corporate Governance addresses in its work the good practices in this area for SMEs and some codes in the MENA region being currently drafted address enterprises of varying size and ownership structure, not only listed companies (i.e. Morocco). This Taskforce is also currently in the process of preparing policy recommendations on corporate governance of banks, which has an indirect impact on their lending practices.

Recommendation:

> Consider the various institutional models adopted in several MENA countries to encourage VC investment in SMEs (including family owned SMEs).[17]

B. Encourage Listing on Foreign Stock Markets

Developed efficient capital markets are an important precondition for a buoyant VC industry, insofar as public offering is one of the four methods of exit (the other being trade sales, private sales and share purchase). While trade sales are generally much larger than Initial Public Offerings (IPOs) in volume terms, IPOs are important in establishing valuation, for listed and non-listed companies.

Public listing is also seen as the goal of most entrepreneurs and investors in the venture capital cycle. Developed stock markets, and in particular, exchanges that specialise in high growth companies (such as NASDAQ) are not present in the region, despite current record levels of IPOs, especially in the Gulf.

While it is true that the ratio of market capitalisation to GDP of the GCC countries has risen enormously over the past 3 years and is now approaching that of many developed markets, the ratio of traded equity to GDP remains lower than in other emerging markets. MENA markets also have a low weighting in most global emerging market indices, despite the tremendous boom over the last 3 years. Furthermore, stock market fluctuations, which have resulted in a 40% decline of the Dubai Financial Market since the beginning of the year, and 11% decline on a single day in March 2006 alone[18], undermine investor confidence and create additional difficulties for fund managers at the exit stage.

Recommendation:

To the extent that domestic markets may not be able to accommodate listing, facilitation of domestic companies' listing on overseas markets should be considered.

In addition, develop separate listing requirements for second tier stock exchanges to facilitate the listing of smaller enterprises.

Consideration might also be given to cross-listing of securities on the regional stock markets and the creation of a regional trading platform.

C. Substitute the Role of Institutional Investors and Large Banks in VC Development

In Europe and the US, VC funds are financed by large institutional investors and banking institutions, respectively. In the US, institutional investors (pension funds and insurance companies) are key actors, accounting for as much as 40% of VC finance.[19] The ability of these actors to participate actively in VC is related to the fact that they control a large share of national assets and have long term liabilities, which gives them both the necessary liquidity and the ability to absorb risk. In Europe, which predominantly features bank-based financial systems, VC financing originates not from institutional investors, but from the banks themselves. For instance, in Austria, Germany and Italy, as much as 50% of funds raised between 1992 and 2002 came from banks.[20]

Most of the MENA countries possess neither the institutional investors capable of investing in the VC industry, nor the banks interested in being players in this industry. In MENA countries, with the notable exception of Saudi Arabia, Egypt, Jordan, and Morocco, which have pension schemes, institutional savings are very small. However, even in these countries, investment in domestic capital markets by pension funds is rather small. Additionally, in virtually all MENA countries, other forms of institutional savings such as insurance and collective investment schemes represent low shares of financial sector assets. For instance, the contribution of insurance sector to MENA GDP was only 1% in 2005.[21] Thus, institutional investment does not seem to be an available option of VC development in the region.

The corporate sector, on the other hand, can be a supplier of funds. Private companies can create VC subsidiaries that seek projects in sectors related to the business of the parent company. Alternatively, individual wealth in the region - alluded to earlier - may be used as a substitute for bank or institutional investments. After all, in the United States, the main sources of venture capital funds in the early years of the industry were high net worth individuals, foundations, universities and charitable endowments.

Recommendations:

Develop collective schemes to facilitate retail investment in alternative investment instruments.

D. Overcome Barriers to Innovation

Significant progress is possible in an environment featuring a high rate of innovation and a framework that facilitates the transformation of ideas into concrete business plans. While there may not be a lack of interesting business ideas in the region, formalising and commercialising them represents a challenge. To respond to it, authorities have institutionalised programmes such as business incubators to assist entrepreneurs materialise their ideas and raise the level of patentable innovation.

The impact of business incubation in Europe has been highly positive with 90% of start-ups set up inside the incubator still active 3 years later. Furthermore, the 900 business incubators active in Europe have assisted in creating 29000 enterprises annually, a rate which is higher than for enterprises set up outside such incubators.[22] Thus, experience corroborates that supporting incubators can be a cost-effective way in which national or sub-national authorities can facilitate development of entrepreneurship.

Given MENA's unemployment and diversification challenges, this strategy appears to be highly relevant. In particular, MENA governments might consider contributing to the development of incubators. Creating strategic linkages between incubators and VC funds should be facilitated as well, since research shows that business incubation and venture capital linkages are often not optimal.[23] As the Bahrain Business Incubator experience demonstrates, this strategy has a significant payoff.

Box 2. Bahrain Business Incubator Centre

Bahrain Business Incubator Centre (BBIC), financed by the Bahrain Development Bank and implemented by UNIDO, provides capacity building and training to young entrepreneurs seeking to set up their own business, counseling to develop and assess the viability of projects, and assistance with business plan creation. Depending on the viability of the business plan, it also arranges linkages with the Bahrain Development Bank. The BBIC facilitates the formation of joint ventures and/or partnerships and establishment of technology tie-up. The BBIC is owned by the Finance Ministry, Pension Fund Commission (PFC) and the General Organisation for Social Insurance. The Bahraini model has proven successful and UNIDO/ARCEIT is currently being replicated in other locations in Bahrain, as well as Kuwait, Saudi Arabia, Syria, and Lebanon.

Source: Bahrain Business Incubator Centre.

This is not to suggest that the role of risk capital is confined to funding high-tech enterprises. Risk capital finance needs in the region are certainly not limited to innovative sectors, and may also be a useful source of finance for enterprises in other sectors.

Recommendation:

Consider benefits of fostering entrepreneurship through business incubators.

Facilitate linkages between business incubators, research institutions and sources of finance.

E. Create High Tech Regional Clusters

While business incubators can be beneficial, a high rate of innovation *per se* does not translate into economic growth. Experience shows that VC activity tends to be geographically clustered in areas abundant with skilled human capital, universities and research centres, legal and technical services. The geographic concentration is consequential to VC growth insofar as clusters support large scale innovation, thus leading to a large deal flow. Large deal flow is in turn crucial for the sustainability of a VC industry since, as experience demonstrates, a great majority of deals are rejected. As well as supporting knowledge creation and innovation, clusters also facilitate the creation of finance networks specifically targeted towards its capital needs, including the attraction of business angels.

In the MENA region, this clustering has been difficult to achieve to date, for reasons connected to the rate of innovation, intellectual property protection issues, as well as a general lack of confluence of available finance with technical innovation on a scale necessary to motivate venture capital. An important exception to this has been Dubai.

Box 3. Dubai – A Success Story in Clustering

Dubai has emerged as an impressive technology and finance cluster, attracting well-known technology players such as Oracle, Microsoft, Cisco Systems, HP, IBM, and Compaq. The region has been identified as one of the four global technology hot-spots by the International Data Corporation.

The cluster is primarily comprised of the *Dubai Silicon Oasis* (DSO), the *Dubai Internet City* (DIC), and is supported by the *Dubai International Financial Corporation* (DIFC). All the actors have benefited from the geographical proximity.

The DSO, opened by initiative of the Crown Prince of Dubai, is a high-technology park for the microelectronics and the semiconductor industry, where investments are estimated to exceed US$10 billion over a period of 20 years. The DIC provides a knowledge economy ecosystem that is designed to support the business development of Information and Communications Technology (ICT) companies. It is the Middle East's biggest IT infrastructure, built inside a free trade zone and has the largest commercial IP Telephony system in the world. This constellation of high-tech knowledge firms and financial services has proven to be highly successful. It was greatly facilitated by the UAE government who created an environment where foreign companies could enjoy 100% tax-free ownership, 100% repatriation of capital and profits, no currency restrictions, easy registration and licensing, and protection of intellectual property.

Source: *Dubai Silicon Oasis* (DSO), 2006.

Given that technology clusters can generate substantial advantages for national competitiveness, and that VC tends to show better returns when it is channelled to start-ups in existing technology clusters, supporting the creation of such clusters is an important policy priority. For instance, public policy can foster innovation by building science parks or business incubators close to universities and research facilities. Regulators should aim to meet, as much as possible, the criteria for developing a

successful cluster, including provision of capital resources, intellectual capital, entrepreneurial climate, legal regulatory environment, market for technology products and a stable political framework.[24]

Recommendation:

Create an economic climate conducive to the emergence of centres of high technology investment. Focus venture funding on knowledge-based clusters of enterprises, universities, support services based on existing models such as in the U.A.E, Dubai or Qatar or Morocco.

Box 4. Casablanca Technopark

The Casablanca Technopark is also an excellent example of business incubation in the region. The Casablanca Technopark is managed by a private company (the Moroccan Information Technology Company) and supported by InfoDev. This facility provides clients with the latest technologies, along with a set of general services and technical facilities. The Casablanca Technopark is currently hosting 130 companies, most of them are start-ups and SMEs in the ICT sector. Multinational companies, training and R&D centers are also tenants in the technopark. This facility has been renowned for capacity building, especially for the integration of IT to the overall innovation process, monitoring functions of the tenants' progress, the transmission chain of knowledge, and functions related to marketing and networking functions for the tenant companies.

Source: Casablanca Technopark.

F. Address Deficiencies in the Regulatory Environment

Legal and regulatory infrastructure is equally crucial for development of a local PE/VC industry or attraction of foreign equity. The aspects of regulatory environment most relevant to PE firms include transparency, taxation structure, corporate governance framework, intellectual property legislation, as well as commercial legislation.

- **Taxation**. Since venture capitalists depend upon capital gains for their income, the industry tends to advocate for low rates of capital gains taxation. The venture capital industry argues that taxation should occur only at the time of sale and at the capital gains rate, rather than at the rate of ordinary income. Some countries have responded to this demand by providing tax relief for various form of investment in unlisted companies or companies listed on second tier of growth exchanges. Capital gains taxation has also been recently reduced in several European countries. A number of MENA countries have recently introduced reforms to their tax laws, however, it remains to be seen to what extent they are competitive with tax structures prevailing in other emerging markets.

Recommendations:

Assess existing tax and regulatory systems to eliminate unnecessary complexity in tax treatment of capital.

Evaluate targeted tax incentives for venture capital investment. Basic tax provisions should be assessed to ensure that they are not impeding to capital formation.

- **Intellectual Property**. Intellectual property protection is another a key feature of the regulatory environment conductive to VC creation. Intellectual property is integrally connected to value creation in a technology based enterprise and as such, is a critical pre-condition for attracting VC capital. Insofar as the potential investors want to evaluate both the strength of the innovation and the ability of the entrepreneur to motivate commercialisation, the nature of patent and trademark protection is important. In fact, developing strong IP legislation in MENA countries remains a priority. Although country-specific variations remain, regional performance in this regard remains rather weak.

  Recommendation:

  Review the legal framework related to intellectual property protection to ensure sufficient incentives for innovative activities exist.

- **Commercial Legislation**. While legislation which provides incentives for the establishment of enterprises and venture capital funds is crucial for further development of this industry in MENA countries, a legal framework providing for exit of unsuccessful enterprises is equally necessary. In particular, such a framework should specify clear insolvency procedures and standards (including accounting standards) in order to improve the security of financial transactions.

  Recommendation:

  Review commercial legislation to improve the security of financial transactions and to provide financial relief in cases of default and insolvency.

G. Create Conditions for Attracting Foreign Equity

For MENA regulators, attraction of foreign equity is important insofar as international capital can both augment local financing, provide opportunities for domestic venture funds and investors to undertake larger syndicated deals and gain venture investment management experience. The latter is crucial for development of local fund management and related skills - a factor which until recently has been lacking in the region. Attraction of foreign PE is all the more important given the fact that foreign equity and US venture capital firms in particular are looking to expand into emerging markets in the coming years.[25]

Rather than implementing completely inward-oriented programs for development of a self-contained VC industry, MENA governments might want to implement policy reform measures aimed at attracting global equity flows. This implies evaluating a set of regulatory policies relevant for foreign direct investment attraction. Participation in the MENA-OECD Investment Programme can serve as an important signal for the willingness of MENA governments to commit to investment climate reforms.

Recommendations:

Review business regulations and the legal framework with a view to facilitate investment by foreign venture capital firms as part of the MENA-OECD Investment Programme and initiatives of its partners.

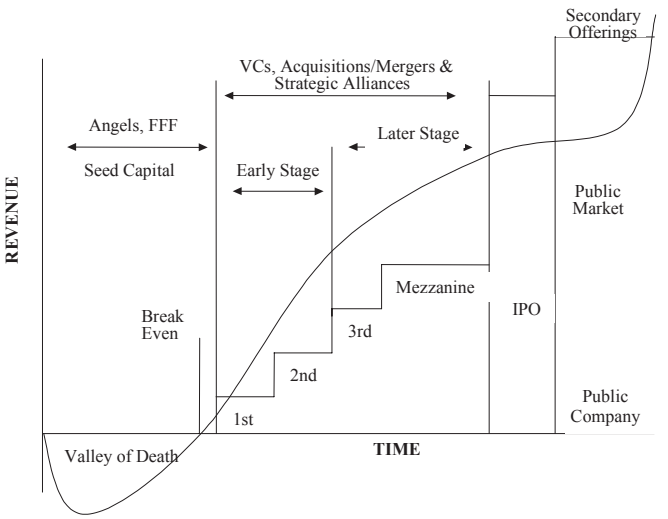
Review FDI regulation to determine whether policies discourage foreign acquisition of domestic companies.

Facilitate creation of alternative investment pooling vehicles, such as funds-of-funds.

H. Close Gaps in the 'Financing Ladder'

Given the fact that lack of financing is typically most prominent at early stages of enterprise development, government measures, either directly through subsidies or indirectly through participation in private sector projects, are crucial at this stage. As the figure below demonstrates, this early stage represents the so-called 'Valley of Death' which is usually bridged by business angel financing, whereas venture capital funds tend to express greater interest a later stage of enterprise development (Figure 3).

Figure 2. Figure 2. Financing Cycle



Source: Cardullo, 1999.

To the extent that this funding deficiency exists, and a potentially innovative enterprise may not reach a point where venture capital funds would traditionally be interested in participating, a role for public policy exists. Consequently, MENA governments may wish to consider providing support in the form of guarantees by lowering the risks involved to the financier at these early stages, keeping in mind the principle of risk-sharing. Additionally, the operation of business angels should be encouraged, primarily via provision of infrastructure support. At the same time, education to increase entrepreneurs' awareness of the different types of financing available to them would also be complementary to the proposed measures.

Recommendations:

Take note of the need to develop a range of appropriate financing mechanisms at all points along the 'financing ladder' and target public schemes to financing gaps (e.g. start-up firms).

Consider creating special public funds through which public sector entities can make equity investments in developing enterprises, keeping in mind the principle of risk-sharing.

Evaluate public equity funds and phase-out when private venture market matures.

CONCLUDING REMARKS

The MENA region could be a hospitable environment for the rise of a venture capital culture given the liquidity currently present in the region and the growth of Islamic financing models conducive to VC development. Nonetheless, the analysis of the PE/VC industry seems to suggest that it is not completely developed relative to its potential given the economic size of the region. Due to a range of structural, administrative and regulatory barriers, securing risk capital for innovative firms in the region remains a challenge, particularly for companies in the high tech sector and at early financing stages.

This is a key trend given that a lack of financing at early stages of an enterprise development has particularly significant consequences for its sustainability and rate of innovation. Risk capital finance needs in the region are, of course, not limited to innovative sectors, and may be a useful source of finance for enterprises in more traditional sectors. Given the damaging impact of the shortage in financing to the development of entrepreneurship and innovation, MENA governments' potential role in this process is to assess any gaps in the financing 'ladder' and address them through appropriate policy responses.

NOTES

1. Eid, 2005.
2. EU, 2006.
3. WB, Doing Business Database, 2005.
4. EU, 2006.
5. Middle East, Issue 364.
6. Deloitte, 2005.
7. EMPA Newsletter, Issue 1, 2006.
8. E&Y, 2005.
9. EFG-Hermes, 2005; Gulf Business, April 4, 2006.
10. EFG-Hermes, 2005.
11. Gulf Business, April 4, 2006.

12. EMPEA, 2005.

13. GVCA, 2006.

14. EU, 2006.

15. MEED, 24-30 March 2006.

16. EU, 2006.

17. Various models have been adopted to provide investment to SMEs in MENA countries ranging from collaboration between business incubators and development banks to providing funds with incentives to invest in local SMEs.

18. MEED. 17-23 March 2006.

19. NVCA, 2005.

20. Thompson, 2006.

21. Union of Arab Banks, 2005.

22. EC, 2002.

23. Callegati, E., Grandi S., and Napier G. (2005).

24. Earnst &Young, 2005.

25. Deloitte, 2005.

REFERENCES

Abraaj Capital (2003), The Middle East Private Equity Market Opportunity.

Baygan, G. (2003), Synthesis Report: Venture Capital Trends and Policies. OECD, Paris.

Callegati, E., Grandi S., and Napier G. (2005), Business Incubation and Venture Capital: An International Survey of Synergies and Challenges. Joint IPI/IKED Working Paper.

Cardullo, M. (1999), Technological Entrepreneurship: Enterprise Formation, Financing and Growth, Research Studies Press Ltd., United Kingdom.

Cardullo, Mario (2004), Intellectual Property – The Basis for Venture Capital Investments. Office of the Undersecretary, International Trade Administration, US Department of Commerce.

Da Rin, M., Nicodano G. and Sembenelli A., (2004). Public Policy and the Creation of Active Venture Capital Markets. Working paper 270, University of Bocconi, Italy.

Deloitte (2005), Venture Capital Goes Global.

Eid, F. (2005), Entrepreneurial Finance for Job Creation in the Arab World: Elements of a Strategy. MENA-OECD Programme Stocktaking Report, OECD, Paris.

EFG-Hermes (2005), Arab Private Equity Industry. Prepared for the 5th African Venture Capital Association Conference in Kenya.

EU (2006), Access to Finance for SMEs of the Middle East and North Africa Region. Experts Group Report.

Ernst and Young (2005), Global Private Equity: Venture Capital Insights Report 2004-2005.

EVCA (2005), Annual Survey of Pan European Private Equity and Venture Capital Activity.

EVCA (2001), Policy Priorities for Private Equity. White Paper.

Middle East Economic Digest, 24-30 March, Vol.50, no 12.

Soderling, L. (2005), Is the Middle East and North African Region achieving its trade potential? The International Monetary Fund, Working Paper 05/90.

Thompson J. (2005), Diversifying MENA Economies to Improve Performance. MENA-OECD Programme Stocktaking Report, OECD, Paris.

Thompson, J. OECD (2006), SME Growth –OECD Keynote Report. Working Party on SMEs and Entrepreneurship.

World Bank (2005**),** Middle East and North Africa Economic and Development Prospects: Oil Booms and Revenue Management.

Zawya (2006), Private Equity Monitor.

TABLE OF CONTENTS

Part I

Outcomes of the MENA-OECD Investment Ministerial Meetings, 2006 and 2007
Key Documents Adopted by Ministers

1.1 **First Ministerial Meeting, Attracting Investment to MENA Countries Common Principles and Good Practice, February 2006**

I.1.1 Ministerial Declaration 10
I.1.2 Recommendations of the Working Groups 13
I.1.3 Joint Business Statement 18

1.2 **Second Ministerial Meeting, Making Reforms Succeed: Moving Forward with the Investment Policy Agenda, November 2007**

I.2.1 Ministerial Declaration 24
I.2.2 Recommendations on Tax Policy Development Supportive of Investment 29
I.2.3 Joint Business Statement 31
I.2.4 Declaration on Fostering Women's Entrepreneurship in the MENA Region 33

I.3. **MENA-OECD Investment Programme Achievements and Directions** 37

Part II

MENA-OECD Investment Policy Overviews

II.1. **Venture Capital Development in MENA Countries: Taking Advantage of the Current Opportunity** 47

II.2. **Towards a New Generation of Foreign Investment Laws: MENA-OECD Good Practice** 65

II.3. **International Investment Agreements Concluded by MENA Countries** 121

II.4. **Policy Advocacy Function of Investment Promotion Agencies and Business Associations in the MENA Region** 157

II.5. **One-Stop Shops for Business Formation in the MENA Region** 183

II.6. **Effective Strategies for Communicating Economic and Investment Climate Reforms to the MENA Region** 203

II.7. **Tax Incentives for Investment: A Global Perspective Experiences in MENA and Non-MENA Countries** 225

II.8. **Regulatory Frameworks for Successful PPPs in MENA Countries: Emerging Good Practice** 263

II.9. **Building Sound Insolvency Systems in the MENA Region** 293

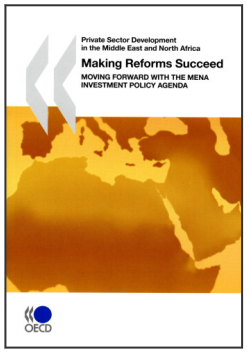
AGENDAS

Annex A **MENA Investment Ministerial Meeting 2006**
King Hussein Bin Talal Convention Center
Dead Sea, Jordan, February 2006 303

Annex B **MENA-OECD Investment Programme Business Day**
Preceding the 2006 MENA Ministerial Meeting 307

Annex C **Second MENA Ministerial Meeting on Investment "Making Reforms Succeed: Moving Forward with the Investment Policy Agenda"**
November 2007, Cairo, Egypt 309

Annex D **First MENA–OECD Women Business Leaders Forum**
November 2007, Cairo, Egypt 313



From:

Making Reforms Succeed

Moving Forward with the MENA Investment Policy Agenda

Access the complete publication at:

https://doi.org/10.1787/9789264052826-en

Please cite this chapter as:

OECD (2008), "Venture Capital Development in MENA Countries: Taking Advantage of the Current Opportunity", in *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264052826-5-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.