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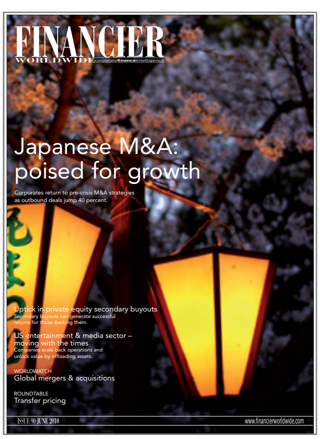

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KINGDOM OF SAUDI ARABIA

Diversification and investment drive Saudi growth

BY KEVIN T. CONNOR, DALE E. STEPHENSON AND ZIAD G. EL-KHOURY

Despite showing some of the strongest M&A growth worldwide in 2004-2007, the recent financial crisis has shown that the Middle East and its oil-rich Gulf region are not immune to global economic forces. Indeed, as the debt woes in Dubai have shown, even the most dynamic of markets can be brought back to ground suddenly. Importantly though, the same factors and fundamentals which led to the previous growth in Middle East M&A activity remain present and are in fact improving at a rapid rate in several key countries, most notably the Kingdom of Saudi Arabia. The significant strides being made in certain key areas will not only result in deal activity in the region returning to pre-crisis levels but at an accelerated pace for years to come.

That the worst is over is borne out by recent figures published by Thomson Reuters, noting that M&A volume in the Middle East tripled during Q1 2010, rising from US$2.5bn in Q1 2009 to US$10.7bn. And according to the first GCC M&A Barometer Survey conducted by Zawya, the outlook of investment banks is optimistic through 2011, with many expecting annual M&A volume in the six GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE) to reach US$100bn. Historically the GCC has accounted for approximately 10 percent of global M&A activity, and most agree that Saudi Arabia – the largest economy in the region holding one-fourth of the world's petroleum reserves – will emerge as the leader along with Qatar and Abu Dhabi. This article considers the significant potential for M&A growth in Saudi Arabia, focusing on key drivers and sectors to watch.

Mirroring the global mantra of 'back to basics' the markets have increasingly focused on Saudi Arabia. Comprising more than half of the collective GDP attributed to the GCC, Saudi Arabia has emerged as the country of choice for investment bankers, private equity funds, developers, financiers, and professional advisers. No longer attracted solely by Saudi Arabia's oil wealth (though this remains a critical factor in funding massive infrastructure and development projects), the markets have become increasingly aware that something significant is taking place in a country marked by a rapidly growing population, ever increasing consumer demand, a deep commitment to education, and an overarching sense of taking its rightful place amongst the leading global economies. Indeed, as the only member of the G20 that also belongs to the OPEC cartel, Saudi Arabia has been credited by the International Monetary Fund (IMF) with playing a critical role in helping to stabilise oil prices during the global recession. When other key players such as Dubai were facing a debt crisis and economic contraction, Saudi's banks were not overextended in real estate and more effectively weathered the storm. While the UAE suffered major real estate devaluation and GDP contraction of 3.5 percent in 2009, Saudi Arabia actually posted modest growth and is on track for continued stable performance.

Under the guidance and direction of King Abdullah, Saudi Arabia has been steadily implementing a series of initiatives to make the country more competitive and investor friendly. One positive outcome of these initiatives has been the World Bank moving Saudi Arabia from 67th to 13th on its ease of doing business scale over the past four years, with the Kingdom committed to an ambitious restructuring and investment program that aims to achieve recognition this year as one of the 10 most competitive economies in the world. Regionally, Saudi Arabia is ranked number one as the easiest place to register property, get credit, and start a business. It is also the largest recipient of foreign direct investment in the Arab world and has substantial available capital to invest in viable projects. Overall, the IMF has concluded that the outlook for the Saudi economy "remains broadly positive" with real GDP growth in the current year projected at 3-4 percent. Driven by high oil revenues and prudent fiscal management, Saudi Arabia has reduced its debt from 100 percent of GDP to become a creditor nation with recent budget surpluses and maintains foreign financial reserves estimated at more than US$500bn. Citing "the continued strong state of government finances, which have largely withstood oil price volatility and the global economic crisis", Moody's recently raised the Kingdom's credit rating one notch to Aa3, the fourth-highest grade. With 30 percent of its budget allocated to education, Saudi Arabia is also investing in future human capital at a rate equivalent to 5.8 percent of GDP – nearly double the average of other GCC countries and eighth highest in the world.

Another key focus has been on liberalisation of the telecommunications markets, as evidenced by the issuance of two new mobile (2G) licences in 2004 and 2006, as well as other licences for data and 3G services. In addition to the direct and immediate impact the issuance of such licences had on the M&A market, the creation of a more independent and transparent regulator has stimulated significant sector growth in the telecommunications industry and will, in turn, fuel future M&A growth in that sector. Another key driver of opportunity is embedded in Saudi Arabia's push to open its markets since becoming a full member of the WTO on 11 December 2005. The myriad changes engendered by Saudi Arabia's WTO admission, and especially market liberalisation, are creating a deeper and more stable platform to support and stimulate growth and deal activity across sectors. At the same time these many initiatives and changes are taking place, Saudi Arabia has also embarked on one of the most ambitious investment programs (estimated at more than $US400bn between 2009 and 2013). These investments cut across many sectors but are especially directed to infrastructure development including petrochemical and natural gas facilities, entire new 'economic cities', major universities, ports, transportation, water desalination, and power plant construction. Saudi Arabia is also reviewing carefully all of its options in the sphere of privatisation, where it has identified US$800bn of opportunities across 40 business sectors for outside investment to help diversify its economy. Though by no means certain at this point, recent developments suggest that significant privatisation in the near term could be another major economic driver.

A direct result of these and other changes has been a significant increase in economic activity in several sectors, such as financial services, telecommunications, insurance, transportation, real estate and construction. A corollary of the rapid growth in these sectors and encouraging competitiveness is the sheer number of players in, or entering, these fields. This phenomenon in and of itself will undoubtedly lead to sector consolidation, reinforcing and furthering M&A activity and opportunities in the Kingdom. For example, the relatively recent regulation of the insurance sector has led to the formation and market entry of literally dozens of Shariah compliant insurers, with more on the way. As with past consolidation in the financial services ▸▸

arena, there is little doubt this is a sector that will witness a wave of consolidation in the near term. And consolidation across these and other fields will be an engine driving deal growth for years to come.

While the volume and level of M&A transactions will continue to expand, there are market, cultural, legal, and practical issues in realising a transaction in Saudi Arabia which must be taken into account. For example, while consolidation is leading to more deal activity, investors should not assume that the legal infrastructure and transactional experience level will be consistent with international practice. Although Saudi businesses and professionals are adjusting and developing new skills and awareness, every M&A deal may face certain challenges. For example, a tradition of family-owned businesses will mean that despite the desire of the seller to sell and the buyer to buy, there may be very little 'hard' documentation traditionally common to the due diligence phase of a transaction. Public information on companies may be limited and difficult to obtain, and the traditional culture is inclined towards maintaining privacy. And, while certain sectors are being liberalised, it does not mean that the underlying regulatory regime or related infrastructure currently exists to facilitate a transaction. For example, a foreign investor seeking to acquire assets in a regulated industry may find that certain nation-of-origin ownership restrictions mean that the buyer cannot satisfy Saudi licensing requirements. While there are almost always ways to structure around such hurdles, parties to Saudi transactions should be aware of these important considerations.

Overall, Saudi Arabia is emerging as a key regional and global market that will see heightened M&A activity in the near term and beyond. The country has been pursuing critical economic and institutional reforms at a rapid pace to attract and foster such opportunities, making it an increasingly popular choice for investment and development. While real estate will likely remain less active in the near term, significant activity is anticipated in other sectors including telecommunications, infrastructure, construction, transportation, healthcare, natural resources, education, energy and financial services. ■

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For more than 20 years, the lawyers of **Squire Sanders** (www.ssd.com) have handled matters throughout the Middle East including Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, the United Arab Emirates and Yemen. In addition to assisting local and multinational companies, financial institutions and investors in establishing or expanding their operations in the Middle East, the firm has advised governments and governmental instrumentalities throughout the region. Working closely with independent network firm **EK Partners & Al-Enezee Legal Counsel** in Riyadh and **El-Khoury & Partners** in Beirut (EKP, www.ekplegal.com), the firm's team seamlessly provides clients with the optimal combination of local presence, legal expertise, sector experience, language capacity and cultural understanding. The team of Squire Sanders and EKP lawyers have the skill and experience to handle a broad range of matters throughout the Middle East, including those involving corporate law and governance, cross-border strategic transactions, mergers and acquisitions, foreign investment, project finance, private equity, banking, securities (IPOs, private placements, investment funds and Islamic finance), construction, real estate, hospitality, administrative, regulatory, health care, telecommunications, maritime, intellectual property, energy, environmental, insurance, labour and employment, international trade, taxation, litigation and dispute resolution, government restructuring and privatisation.