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SUMMARY

Foreign Direct Investment (FDI) is considered an indicator of economic growth and a catalyst for industrial development. It is important in three ways: (i) capital investments by foreign firms complement domestic savings in increasing the host country's total investments, translating into higher growth rates, capital formation and employment; (ii) FDI is often credited with positive externalities in areas such as technology transfer and labor/management training; and, (iii) FDI growth is now considered a positive market signal for the potential of an emerging economy.

In contrast with FDI, the explosion of private equity investments and venture capital investments in emerging markets is a recent phenomenon. In 2008, more than 210 private equity funds raised an estimated $66.5 billion targeting emerging markets; this compares with only $6.5 billion in 2004. Similarly, private equity and venture capital investments in Egypt grew significantly, with more than $13.1 billion in committed capital invested through 36 funds during the same five year period.

Given the increasing prominence of private equity investments in emerging markets, should governments create similar policies to attract private equity as they do for foreign direct investments? And are there risks from private equity investments that require regulatory interventions?

Is Private Equity the Next FDI? The Case of Egypt & the MENA Region

By Ayman Ismail

Introduction

Over the past two decades, Foreign Direct Investment (FDI) by multinational corporations has grown significantly faster than trade flows, particularly among the world's most developed economies. International economic activity increasingly takes the form of non-arm's-length trade[1] involving foreign production by multinational firms and intra-firm trade by those same companies. It is now estimated that about 30% of world trade is intra-firm (Markusen and Venables 1999). In the 1970s, many host countries' governments and some economists viewed multinational investment as detrimental to the development and welfare of host economies, creating monopoly situations that exploited those economies and stifled local competition. However, views have changed significantly since the 1990s, becoming more favorable to foreign direct investments, suggesting that multinationals have important complementarities with local industries and may stimulate the development of host economies (Markusen and Venables 1999).

Key Policy Recommendations

- Government policy should encourage private equity and venture capital investments, especially funds focusing on new ventures, growth capital and infrastructure.
- Private equity funds could benefit from general improvements in the business environment, deeper stock markets, more engaged banks, and flexible governance/legal structures that can better support the PE business model.
- Sector-specific funds can complement industrial policy to encourage growth and private investments in specific sectors such as communications and information technology, renewable energy, or infrastructure.
- Governments should not shy away from two important and controversial measures that are often opposed by private equity firms: considering regulatory measures to improve transparency of private equity transactions, and introducing a capital gains tax on profits from private equity investments.

[1]Non-arm's-length trade is intra-firm cross-border transactions; i.e., trade between subsidiaries of the same multi-national corporation, rather than trade between independent firms.

Today, foreign direct investments are widely considered to be an indicator of economic growth and a catalyst for industrial development (Markusen and Venables 1999). FDI is important in three ways. First, capital investments by foreign firms complement domestic savings in increasing the host country's total investments. This in turn translates into higher growth rates, capital formation and employment (Ismail 2005).

Second, FDI is often credited with positive externalities in areas of technology transfer and labor/management training. The UNCTAD *World Investment Report* argues that the transfer of technology, knowledge and skills is the most important contribution of FDI to the host economy. FDI's role in the transfer of *hard* knowledge and technology (e.g., technical knowledge of equipment and industrial processes) is particularly important in the manufacturing sector, while the transfer of *soft* knowledge (e.g., organizational and management skills, marketing and sales experience) is particularly important in the services sector (UNCTAD 2004).

Third, FDI growth is now considered a positive market signal for the potential of an emerging economy (Markusen and Venables 1999). FDI inflows to emerging countries are widely monitored by both governments and markets. Growth in FDI inflows is considered an indication of a healthy economic environment and a leading indicator of faster economic growth. In most emerging countries—Egypt being one example— governments are creating dedicated agencies and offering incentive packages to attract FDI inflows.

On the other hand, the explosion of private equity investments in emerging markets is a recent phenomenon. The Emerging Markets Private Equity Association (EMPEA) estimates that in 2008, $66.5 billion were raised by more than 210 private equity funds focusing on emerging markets, compared to $6.5 billion in 2004 (EMPEA 2009). Private equity firms and funds are becoming increasingly important actors in these emerging markets: They act as a source of finance for new enterprises or growth capital for existing ones, as owners and managers of portfolio companies, and as employers and job creators.

Private equity is an alternative investment class that provides investors, both individual and institutional, with professionally managed investment vehicles for equity investing in unregistered securities of private and publicly-traded companies (Fenn, Liang and Prowse 1995). Private equity firms invest in new or existing enterprises with the purpose of increasing their value over the short or medium term. Private equity fund investments come in a variety of different types. In **buyouts**, the fund invests in existing (often distressed) companies through the acquisition of a significant or controlling stake; **venture capital** investments are directed toward new or small companies, often based on technological innovations; and **growth capital** investments provide capital to rapidly-growing companies (Fischbein 2005, Lerner and Leamon 2008).

Private equity funds typically maintain their investments for a limited period of time, usually 3-5 years. During this period, the portfolio company, in the case of buyouts, undergoes financial and operational restructuring or achieves its growth targets; in the case of new innovation, the startup matures. At the end of this period, the private equity fund exits the investment by selling the company either through an initial public offering (IPO) in the stock market, to other companies (trade sale), or to other financial investors (secondary buyout) (Lerner and Leamon 2008; Fenn, Liang and Prowse 1995). Private equity funds usually capture profits that significantly exceed the performance of publicly-traded companies; however, these returns reflect higher risks and volatility, along with the illiquid nature of the investments during the investment period.

Given the increasing prominence of private equity investments in emerging markets, should governments create similar policies to attract private equity as they do for foreign direct investments? And are there risks from private equity investments that require regulatory interventions?

Foreign Direct Investments in Egypt

In the five-year period between 2003-2004 and 2007-2008, FDI inflows to Egypt grew significantly—from an average of US$ 500 million annually during the period between 2000 and 2004, up to $13.2 billion in 2007-2008 (Table 1). This trend may be attributed to two key factors: first, the increase in global and regional liquidity, especially from oil revenues; and second, major policy reforms implemented by the Egyptian government to liberalize the economy and attract foreign direct investments (World Bank 2009).

Private Equity Investments in Egypt

As of mid-2008[2], there were 13 private equity firms managing 36 private equity funds focusing primarily on Egypt, with more than $6.4 billion in committed capital.[3] While eight of these funds (with a total committed capital of $420 million) started operating prior to 2004, the real boom in the private equity investments began in 2004/05 with an additional $6 billion in committed capital between 2004 and mid-2008 (Table 1). In addition to the funds that are focused exclusively on Egypt, there are 35 regional funds that target Egypt along with other countries in the region.[4] Capital committed to these regional funds that include Egypt in its investment targets was around $6.1 billion.[5]

The activities of these funds translated into an increase in the number and size of individual transactions (buy/sell). In the five-year period between 2003/04 and 2007/08, there were 78 recorded private equity transactions, with an average transaction size of $215 million.[6]

Based on these figures, we estimate private equity investments in Egypt to be around $13.1 billion for the five-year period, and $2.6 billion annually (Ismail 2009). This figure corresponds to 1.6% of Egypt's 2008 nominal GDP of $162.3

Table 1: Net FDI Inflows to Egypt (FY2000/01 - FY 2007/08)
(Current US$ million)

	Fiscal Year								
	1990/90 - 2000/01 Annual Average	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Net FDI inflows	1,038.7	509.4	428.2	700.6	407.2	3,901.8	6,111.4	11,053.2	13,200.0
As a percentage of GDP	1.7%	0.6%	0.5%	0.9%	0.5%	4.4%	5.7%	8.5%	8.1%

Note: Figures include foreign direct investments in the petroleum sector as from FY 2004/2005.
Source: Central Bank of Egypt - Balance of Payment time series; Ministry of Investment

[2] Prior to the global financial crisis

[3] Committed capital represents the amount of money that the fund investors commit to the fund at the start. These funds are invested over the first 2-3 years of the fund's life as the fund managers identify good target investments based on their investment strategies.

[4] There are an additional 46 funds with more than $3.8 billion that focus on other countries in the region, but do not cover Egypt.

[5] These $6.1 billion include $1.1 billion prior to 2004, and the remaining $5 billion in the period between 2005 and mid 2008.

[6] Transaction value was available for only 37 of these transactions, totaling $8.0 billion, with an average transaction size of $215 million (Ismail 2009).

Table 2: Private Equity Funds Operating in Egypt
(Current US$ in millions)

Fund Geographic Focus	Year of first closing						
	Prior	2004	2005	2006	2007	N/A	Total
Egypt Funds:							
Number of Funds	8	4	7	5	7	5	36
Fund Size/ Committed Capital ($M)	420	533	2,097	314	2,102	933	6,399
MENA Funds, covering Egypt:							
Number of Funds	9	5	6	5		10	35
Fund Size/ Committed Capital ($M)	1,088	544	1,912	1,410		1,170	6,124

Notes: N/A indicates year of first closing not available
Source: Compiled by author from Zawya, MIT's Emerging Markets Portal (Emergis), and individual funds data, as of July 2008.

billion (World Bank WDI 2009), a level of private equity investments that is significantly higher than the regional average, as well as that of other emerging markets. For example, private equity investments as a percentage of GDP are ~0.3% in the MENA region, compared to 3.2% in the US, 0.8% in the European Union, and 0.5% in emerging markets in Asia (EMPEA 2009).

FDI vs. Private Equity: The Case of Egypt

Over the same period (2003/04 - 2007/08), private equity investments in Egypt grew at a similar rate to foreign direct investments. Prior to 2003/04, private equity investments in Egypt were less than $50 million annually. During the five-year period of 2003/04 – 2007/08, private equity investments are estimated to have been $13.1 billion in total. This amounts to 37.8% of the $34.7 billion total FDI inflows during the same period. It is important to note that FDI and private equity figures are not necessarily mutually exclusive. Depending on the sources of the fund and the structure of the transaction, some private equity funds may also be included as foreign direct investments, especially in the case of offshore funds. It is also important to highlight that private equity funds are often leveraged, using loans from banks or other financial institutions. This helps increase their impact in terms of total value of assets under management. It is useful to compare foreign direct investments with private equity investments in several ways, including (i) the source of the funds; (ii) the destination of the investments in terms of sectors and industries; and (iii), spillover effects and externalities.

In terms of the **sources of funds**, foreign direct investments are direct transfers from multinational corporations with the purpose of building domestic subsidiaries, sometimes through acquisitions (Moran 1998; Chung 2001; Blomstrom and Kokko 2003). These investments are often for the medium or long term. In the case of private equity, the funds are either from domestic or foreign investors (breakdown data not available), and often with a short to medium-term view. Private equity investors provide "patient capital" with a multi-year investment horizon, as compared with short-term investments in stock markets.

In terms of the **destinations of the investments**, in 2007/08 foreign direct investments in Egypt were primarily concentrated in three areas (see Table 3): 48.5% went to create new establishments or expand existing ones (this is the most valuable investment area from an economic development perspective); 31.1% of investment went to the oil and gas sector; 17.4% were in sales of assets to non-residents, and investments in real estate accounted for less than 3.0%. In the case of private equity investments in

Egypt (Table 4), the largest transactions in terms of size were executed in the basic materials sector (e.g., cement and steel), followed by the financial services and oil & gas sectors. However, a large number of small- and medium-size transactions were executed in other sectors such as telecommunications and information technology, agribusiness, and healthcare.

In terms of **spillovers and externalities**, FDI is often credited with transferring technology and management practices from the foreign investor to their domestic subsidiary, as well as with spurring similar development among competitors within the affected industry. These positive externalities have been used to argue in favor of government incentives to attract FDI (Moran 1998; Chung 2001; Blomstrom and Kokko 2003; Louis, El-Mahdy and Handoussa 2004). In the case of private equity, the investors are not a multinational corporation with industry-specific knowledge, but rather are financial investors. However, the role of private equity firms in professionalizing management and business practices may result in other types of positive

Table 3: Sectoral Distribution of Net FDI Inflows in Egypt
(Current US$ millions)

	Fiscal Year					
Sector	2004/05	2005/06	2006/07	2007/08	Total	Percent
New establishments & expansions	925.6	3,347.8	5,227.2	6,400.0	15,900.6	46.4%
Petroleum sector	2,540.2	1,832.2	3,014.8	4,100.0	11,487.2	33.6%
Sale of assets to non-residents	390.8	905.7	2,772.2	2,300.0	6,368.7	18.6%
Real estate	16.5	25.7	39.0	400.0	481.2	1.4%
Net FDI inflows	**3,873.1**	**6,111.4**	**11,053.2**	**13,200.0**	**34,237.7**	**100%**

Sources: Central Bank of Egypt; Ministry of Investment

Table 4: Sector Focus of Private Equity Firms in Egypt, Based on Actual Transactions (2003-2008)

Sector	Number of Transactions	Average Transaction Value (Current US$ million)
Telecoms and IT	16	9.5
Agriculture and Food	11	17.8
Basic Materials	10	1,006.6
Oil and Gas	9	44.3
Financial Services	9	357.2
Healthcare and Pharmaceutical	7	95.1
Infrastructure and Transport	6	n/a
Travel and Tourism	3	n/a
Consumer Goods	3	53.7
Industrial Manufacturing	2	37.3
Media	1	n/a
Construction	1	26.0
Total	**78**	**215.3**[7]

Note: Based on completed private equity transactions in Egypt during the five-year period from mid-2003 to mid-2008

Source: The author, based on data from MIT Emergis and Zawya

[7] Average transaction value is based on only 37 transactions where value was publicly available (Ismail 2009).

externalities. Rather than transferring technological know-how (as FDI is credited with), private equity firms often play a role in the transfer of management practices, board governance and financial practices to their portfolio companies (Ismail 2009).

Financial Entrepreneurs

Based on these findings, it could be argued that private equity firms in Egypt are providing a different type of entrepreneurship that is emerging from the financial sector, as opposed to the traditional entrepreneurship models emanating from industry or technological circles. They are creating new "green field" companies in capital-intensive industries such as oil and gas, cement, transportation infrastructure and manufacturing. They are also providing capital for rapidly growing companies which have limited access to finance from the banking system. In this capacity, some private equity funds are acting as a new breed of "financial entrepreneurs," increasingly playing a positive role in economic development that is comparable to the role played by FDI. This is partly explained by the structural characteristics which characterize this stage of development not only in Egypt, but in most emerging markets. Most economic sectors are fragmented and can benefit from consolidation strategies; many small companies are in need of growth capital, and medium-sized companies can benefit from the professionalization and regional growth opportunities that private equity investment provides. By playing the catalyst role for these types of transformations, private equity firms contribute to economic development.

Governments Policy and Private Equity

Government policy should encourage private equity and venture capital investments in the same way that they do for foreign direct investments, especially new ventures (venture capital and green field investments), growth capital, and infrastructure investments.

Private equity firms could benefit from government support in a number of areas. First, they would benefit from general improvements to the business environment (e.g., reducing government red tape, improving legal protections for investors, or modernizing bankruptcy laws). PE firms would also benefit from deeper stock markets to act as an exit mechanism for their investments. Additionally, bank loans from local banks would provide PE firms with leverage in cases of leveraged buyouts (LBOs). Most banks in Egypt and other emerging markets are reluctant to provide such loans. This is especially true for state-owned banks. However, many banks are starting to move from a lending-model to an equity-investment model through targeted funds or partnerships with PE firms. Finally, PE investors could also benefit from regulations permitting more flexible governance structures, particularly for limited partnerships, which are frequently used by private equity funds in most developed markets, and can better support the PE business model (Ismail 2009).

Sector-specific funds can also be used to complement governmental industrial policy to encourage growth in specific sectors. For example, Egypt and Jordan are encouraging investments in communications and information systems,[8] which would particularly benefit from technology-focused funds, as well as venture capital funds. Similarly, Saudi Arabia, UAE and Egypt are encouraging investments in renewable energy, which could benefit from specialized energy funds.[9] Infrastructure funds can also play a key role in expanding the role of private capital in infrastructure, especially using schemes like public-private partnerships (PPP) or build-own-transfer (BOT).

[8] For example, by establishing technology parks, subsidizing education and training programs to provide trained labor, offering tax incentives to anchor multinational corporations that can have positive externalities, or creating quasi-governmental "industry development agencies" to support the infant industry

[9] For example, by establishing large research institutions like Masdar city or King Abdallah University for Science and Technology (KAUST), setting national targets for renewable energy like Egypt's 20% by 2020, or reducing customs on renewable energy components

Having said that, governments should not shy away from two important and controversial issues that are often opposed by private equity firms: transparency and taxation. Private equity transactions are typically opaque, due to their nature as transactions between private parties. Governments should consider regulatory measures to improve the transparency of private equity firms, funds and transactions, especially as they grow in size and execute more/larger transactions that influence the economy in a substantial way. Second, governments should also consider introducing capital gains taxes on profits from private equity investments (Ismail 2009).

In conclusion, private equity is a rapidly growing investment vehicle in emerging markets, and is likely to grow further as the global markets emerge out of the recession. Governments should take strategic actions to attract and encourage private equity, similar to FDI. However, they should also implement regulatory measures to ensure transparency, and consider introducing capital gains tax on private equity investments.

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