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A new age for family businesses in the Middle East

Managing change and expectations

2017

Contents

Foreword

Family offices continue to be a driving force behind the development and growth of economies across the Middle East. The environment in which they operate is, however, changing. Both external market forces and their own complex internal dynamics are presenting family businesses with major new challenges.

The complicating forces are many. Families are growing in size and within them the baton of leadership is being passed from one generation to another. The region's markets are more mature and sophisticated. Trade is being affected by both the decline in the crude oil price and the tendency for international brands to reassess their regional operating structures, as a result of geopolitical developments.

Family businesses must understand their evolution and that of the markets around them and continue to adapt.

We have conducted in depth interviews, with over 40 of the most prominent family businesses in the Middle East. These families operate across a range of industries through their core divisions, as well as via separate investments.

Our survey serves to provide a barometer of market perception and confidence among family offices within the Middle East and highlights the current internal trends and the challenges faced by these businesses.

The survey covers three broad areas: the current position, management and operations of the businesses; their strategy; and their prospects. We have limited our survey to those family offices operating within the Middle East, to ensure the results are not diluted by any trends, or characteristics of businesses in other regions.

We would like to express our sincere thanks to the family offices who took part in our study for their valuable contributions. We look forward to discussing the results of our survey with you.

Scott Whalan
Partner

Nick Beer
Director

The issues

Over the following pages we will highlight responses from family businesses on a number of key areas; including questions on succession planning, investment committees, return objectives, investment strategy, sector focus, financing arrangements as well as a general market outlook.

The key questions we asked the family businesses include:

01 **What generation within the family is currently involved in the business, either at a board level or managing the day to day operations?**

02 **Do you have a formal succession plan?**

03 **Do you have a formal investment strategy in place and an investment committee which is independent of the board?**

04 **Would you consider your portfolio return objective to be focused on growth or income?**

05 **How frequently do you assess and review the strategic rationale of your capital/value allocation across the group?**

06 **How did you finance your operations and growth last year?**

07 **What are the priorities for your business over the next 12 months?**

08 **How confident are you in the short to medium term prospects of the Middle East markets?**

09 **In which industry sectors do you expect to see most deal activity over the next 12-24 months?**

10 **What do you see as the key strengths of the Middle East North Africa (MENA) market that will drive its long-term growth?**

Managing for the future

One of the first challenges for today's family businesses in the Middle East comes from within: the transition of leadership from one generation to the next.

The transition can be particularly difficult. Cultural and legal considerations add to the difficulties, as does the sheer scale that many businesses have achieved in a relatively short time. But as families grow in number, change becomes inevitable and essential if portfolio returns (and dividends) are to grow or, at the least, to be maintained.

Our survey results indicate that written succession plans are either in place or being prepared by over 50 per cent of respondents.

Many of the plans have been discussed and are understood by the family but have not yet been formally documented and executed.

Our survey also shows that generally the smaller, less diversified families tend not to have a formal succession plan in place. Their approach tends to be this: 'a decision on who will lead the family going forward will be made when the time is right'.

But a written plan formalises the transition, minimises any unnecessary ambiguities and importantly, helps to create a more cohesive long-term strategy for the business: something which all shareholders and management can work towards.

Question: Do you have a formal succession plan?

26.8%
In progress

34.1%
Do not have a formal succession plan in place

39.1%
Have a formal succession plan in place

Families in the Middle East tend to be large and therefore, there may be many 'candidates' to succeed the current leadership.

Strengthening the board

It is the expansion of families as they transition through generations and the historical track record of growth, that is driving the need for greater returns. This continued need for growth, together with complex and often fraught decisions about necessary changes in generational leadership and management, amplifies the need for a more structured governance framework. Ensuring clear roles, policies and processes allows for a more transparent and robust decision-making process, for both family and non-family members.

53.7%
of first generation family members still remain involved with the business

67%
of respondents have members of the family working on a daily basis

43.9%
of the family businesses surveyed have an independent investment committee

Over 50 per cent of first generation family members still remain involved within the business, and to some extent, at board level. However, their involvement in day-to-day operations is materially decreasing. They are inclined to take more of a back seat and in many cases, business operations have grown to such an extent, that it is not possible for them to dedicate the necessary time.

Based on our survey results, families have tended to deal with this challenge in one of two ways. Firstly, second and third generation family members have been handed more active roles. 67 per cent of respondents have members of the family working on a daily basis within the operating companies or subsidiaries of the group. It is beneficial for the company that the next generation of leaders are gaining experience outside their family businesses, and in some cases outside the region. Many who follow this approach believe it provides them with more rounded experience and stronger more diverse business networks.

Secondly, as a number of family businesses have begun to make the transition to a more corporate structure, they have invited non-family members to join the boards of their operating companies, either in an executive or non-executive capacity. Less frequently, senior board positions at a holding company level, are now being occupied by people who are not part of the family.

It is very clear from our survey, that boards are becoming more structured and diverse, as the trend towards corporatisation of family businesses picks up. Further evidence of this trend is the creation of independent committees within the organisation, to oversee key issues such as remuneration, corporate affairs, and investments.

According to the results of our survey, only 43.9 per cent of the family businesses surveyed have established an independent investment committee. However, many other families suggested, that this is an area of focus for them in the coming 12 months. Given the current economic environment, we see this as a welcomed trend that will continue for the foreseeable future. It should lead to a more structured approach in the deployment of capital.

In most instances, investment committees are made up of the C-suite, key investment team members, external advisors and selected family members. According to the respondents, formal investment committees of this kind allow the family to screen investment opportunities more adequately and ensure a sense of objectivity and diligence within their decision-making process. Creating this structure ensures the business is well placed to adapt to markets which are becoming more mature and sophisticated.

Investing for the future

It is evident that one of the most significant challenges now facing family businesses is how to maintain the balance between business goals, such as growth, and family goals, such as preserving the family's values and protecting its wealth. This challenge is magnified by the globalisation of financial markets, which has increased both the accessibility of alternative sources of funding and opportunities for family businesses to grow.

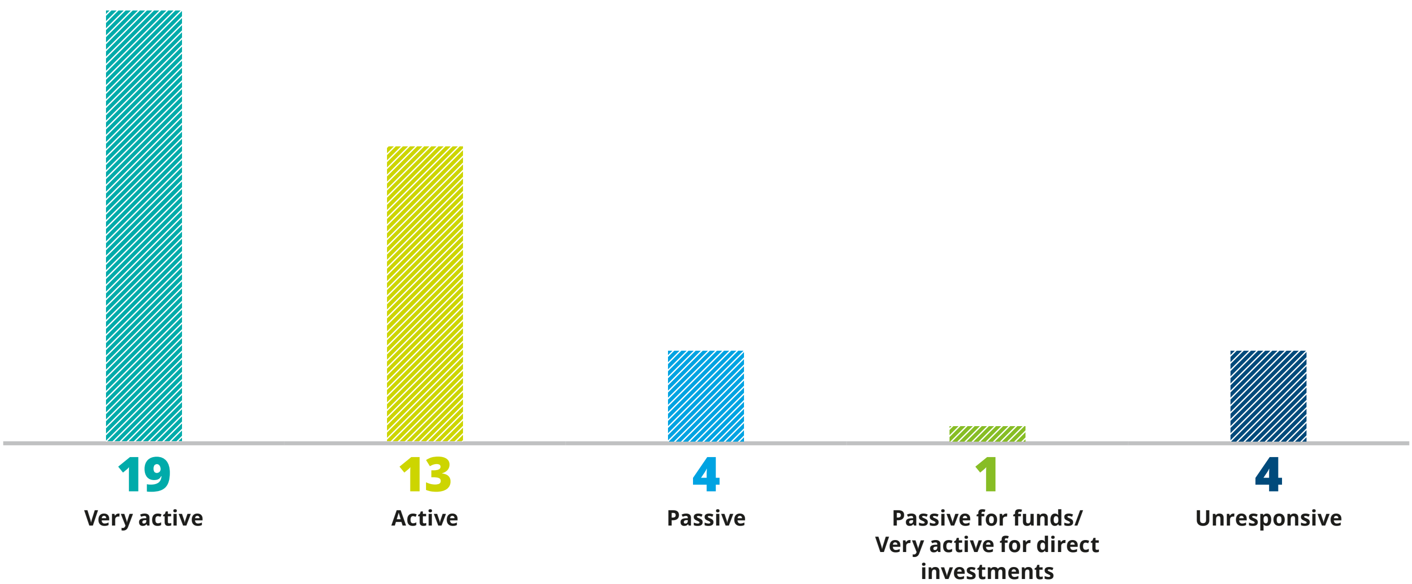
56.3% **of family businesses have a formalised investment plan to drive future M&A activity**

According to our survey only 56.3 per cent of family businesses have a formalised investment plan to drive future M&A activity. The respondents who do not have a plan said, that investment is nonetheless considered key to the group's focus and direction. The absence of a formalised plan, however, increases the risk of misalignment in objectives and investment criteria among both shareholders and management teams, particularly within the larger, more diverse groups. This in turn, may lead to suitable investment opportunities being missed, or mismatched risk and return profiles across the group and its divisions.

Another important factor that contributes to growth and drives family businesses, is the allocation of capital across asset classes and sectors. It is essential to monitor these allocations as market dynamics and conditions change over time. In order to achieve this a family must understand:

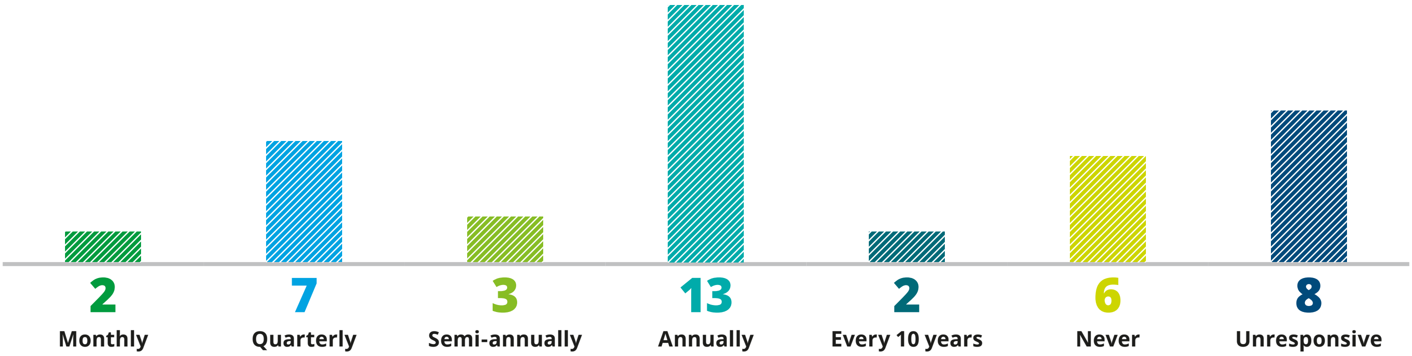
- where their business is exposed (and potentially overexposed)
- how well positioned the business is to take advantage of changes in market conditions over the next 12 to 24 months
- what level of performance would be required at least to maintain the status quo and historical dividend levels.

Question: How active are you at managing your investments?



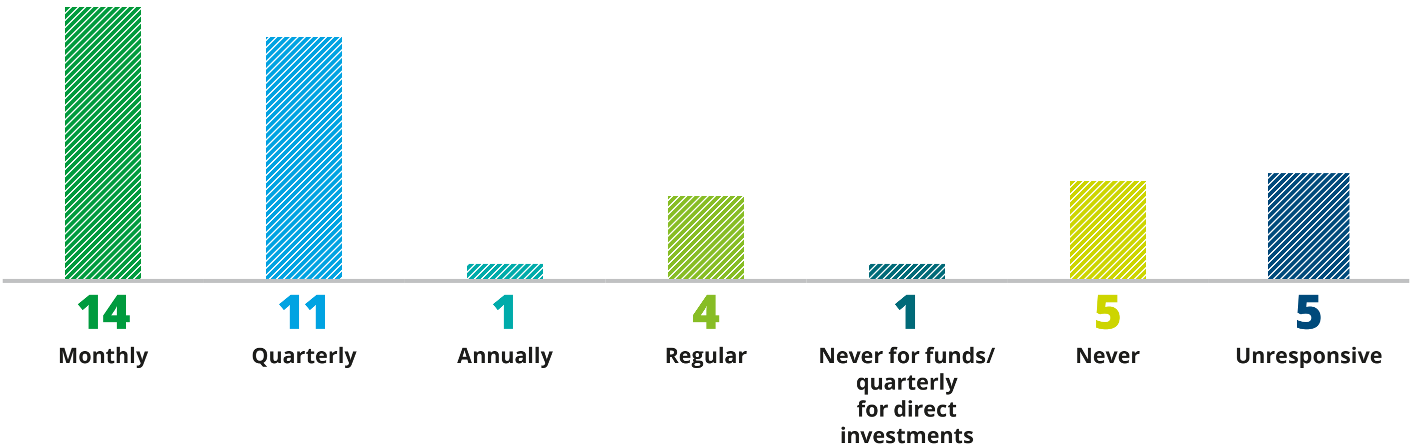
When it comes to the review of capital allocation across the group there was a clear divergence of responses.

Question: How frequently do you assess and review the strategic rationale of your capital/value allocation across the group?



It was common for the businesses to assess their investments against internal and external benchmarks; 31 per cent do so monthly, 27 per cent quarterly.

Question: How frequently do you monitor your portfolio/investments against benchmarks?



Although a large proportion of family businesses said they manage their portfolio actively, our results show that 29 per cent conduct a regular review of their allocation of capital and value, either internally or using external independent support. Considering the changing business landscape across the region, understanding the respective risk and return dynamics is imperative if family businesses are to:

- better assess whether their strategies are appropriate given the current market
- manage and monitor their assets
- make more informed decisions on their current portfolio and potential new opportunities.

We find, however, that even in the absence of a formal investment strategy, most family groups are reassessing the strategic rationale for their capital allocation at least once a year.

29% **conduct a regular review of their allocation of capital and value**

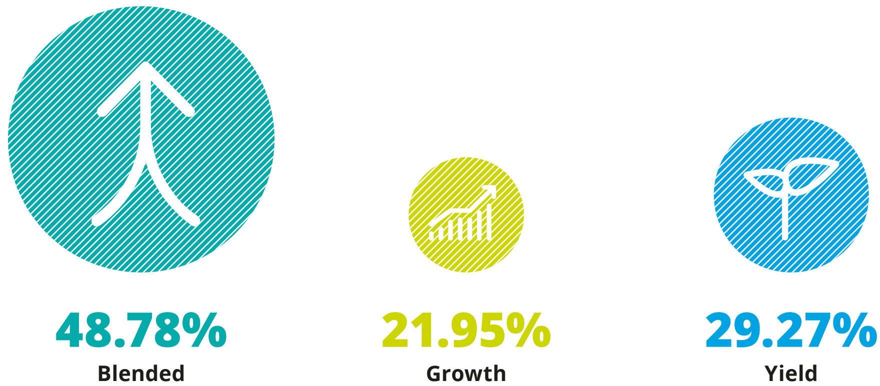
Growth in challenging times

As the region matures, finding appropriate investment opportunities that yield the necessary returns is becoming increasingly challenging. This is making it much more difficult for family businesses to achieve the level and speed of growth, to which they have historically been accustomed.

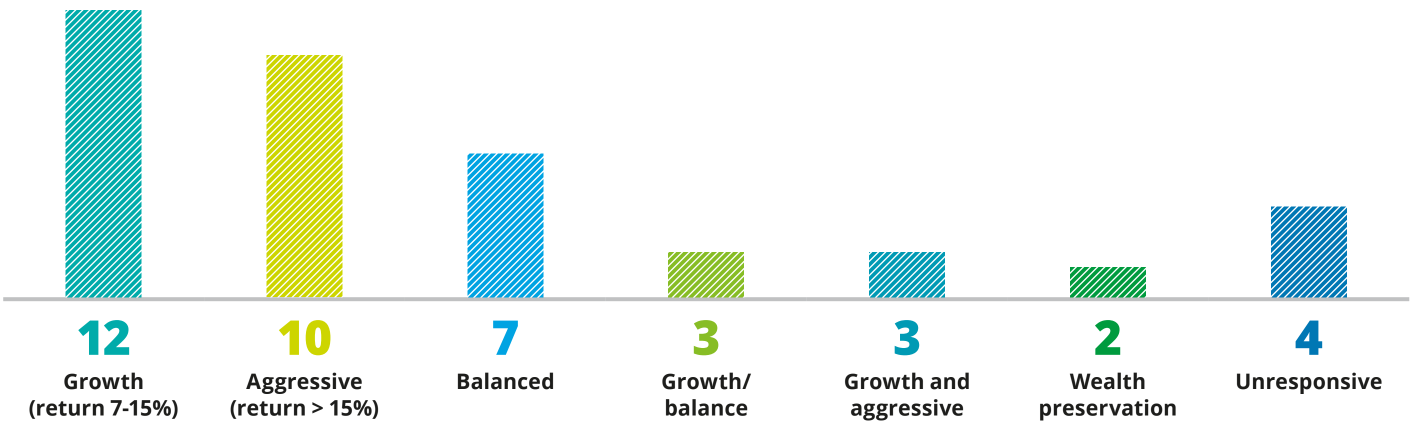
As a result, family businesses have started to explore new markets and assets and are now becoming more willing to consider a change to their risk exposure. Families who may not have the appetite for additional risk, could find it difficult to obtain the returns they enjoyed in the past and therefore need to reassess their expectations for future returns and plan accordingly.

When examining their return objectives, the majority of respondents consider their return focus to be a blend of growth (with cash flows from operations reinvested back into the business to drive expansion) and income (from dividend payments). Of the families we surveyed, 75 per cent suggested that they were required to meet specific income thresholds across the portfolio, to ensure that family members maintain or grow their previous dividend levels. That said, when asked to quantify an annual return objective, the majority of families with such a target, seek a return of 7-15 per cent, which may be considered more aggressive that that typically associated with a yield-focused return objective.

Question: Would you consider your portfolio return objective to be focused on growth or income (yield)?



Question: How do you rate your investment objective, in terms of return?



Financing growth

Contrary to common perception, family businesses are increasing their use of external financing, both from bank finance and other sources.

37%
of family businesses surveyed use debt as a source of funding

51%
of respondents considering debt as an option

Currently, 37 per cent of family businesses surveyed use debt as a source of funding. Going forward that trend may change with 51 per cent of respondents indicating that they are considering debt as an option, to fund their operations and growth over the next three to five years. This shift has been driven in part by the less risk-averse attitude of second and third generation family members. It is undoubtedly, a result of both the need for increased absolute returns and a recognition that debt may be suitably used to achieve an optimal capital structure.

As return demands have grown, so has acceptance across most family businesses of the need for external financing.

This use of external financing should be considered a positive step in the evolution of family businesses. From our experience however, it is critical that as part of this process, they assess their debt financing in terms of capacity and needs and on both a specific asset/investment perspective, as well as at a group level.

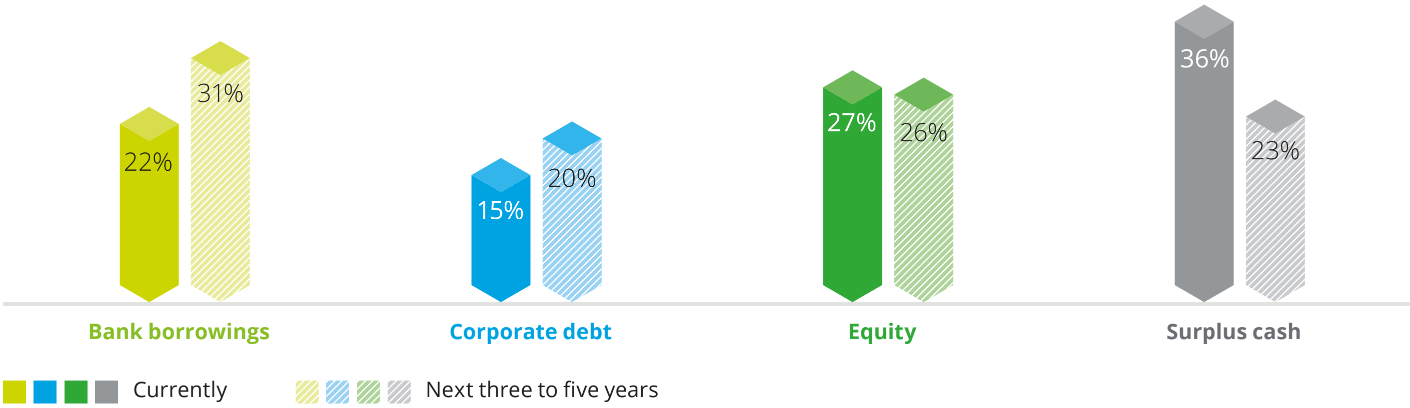
This will ensure that business liquidity is managed as effectively and efficiently as possible across the entire group.

It is also evident from our study that many families, will continue to fund their growth, wholly or partially, from their operational cash flow. This allows them to remain in control of the business without external influence, avoiding scrutiny from financial institutions, or external reporting requirements.

In terms of raising equity financing, a consistent message across those interviewed, was that selling a stake in their holding company, would be very unlikely. However, some of the larger family businesses would consider raising finances in the medium term via an equity listing or bond issuance.

As return demands have grown, so has acceptance across most family businesses of the need for external financing. Whether this is from debt or external equity, it should fuel growth and transaction activity across the region. The pace and extent to which family offices embrace this change will remain modest when compared to corporations.

Question: How did you finance your operations and growth last year and how do you propose to finance your growth in the next three to five years?

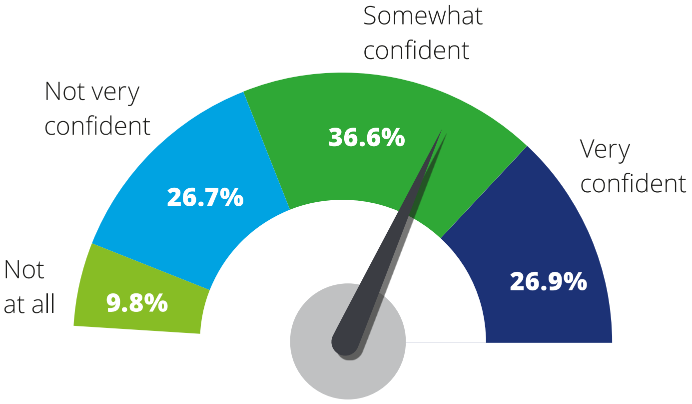


Where to invest?

Family businesses are not immune to the changing macroeconomic conditions across the region.

The decline and recent stabilisation of the global oil price and the cutting back of non-essential government spending, has continued to affect the appetite for and approach to investment across the region. 63 per cent of respondents said they are confident in the short to medium-term growth prospects of the Middle East, and will continue to focus their investment intentions on the region, as long as this is in line with the wider strategic goals of the family business.

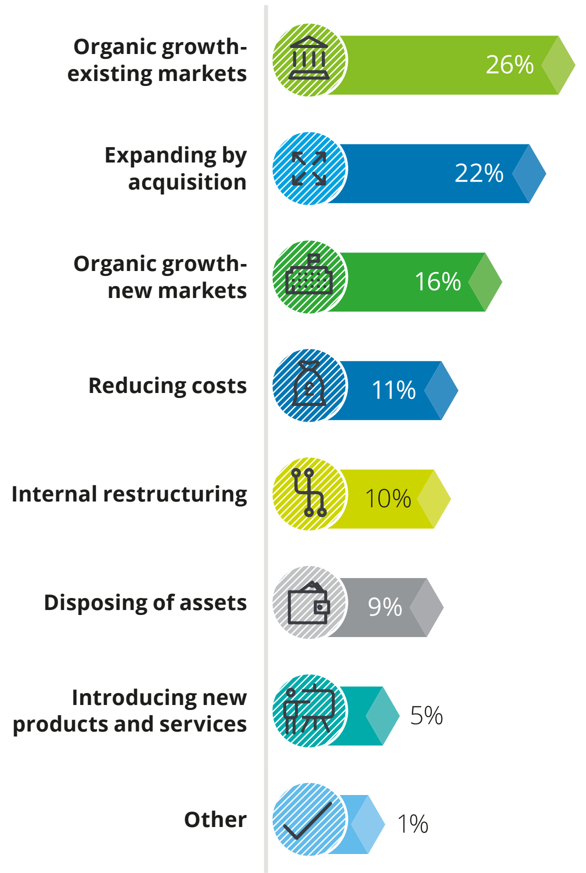
Question: How confident are you in the short to medium term growth prospects of the Middle East markets?



*Extremely confident – no respondents

All families surveyed operate in more than one country within the MENA region, however they hold a significant portfolio of their assets (greater than 50 per cent, on average) within their home/base country. It is not surprising, that over the next 12-18 months, the majority of families will continue to drive growth from their existing businesses. Organic growth is expected to be driven largely by internal restructuring of operations and cost rationalisation programmes. They are also seeking strategically beneficial M&A opportunities, however they will do so predominately in markets where they are already operating.

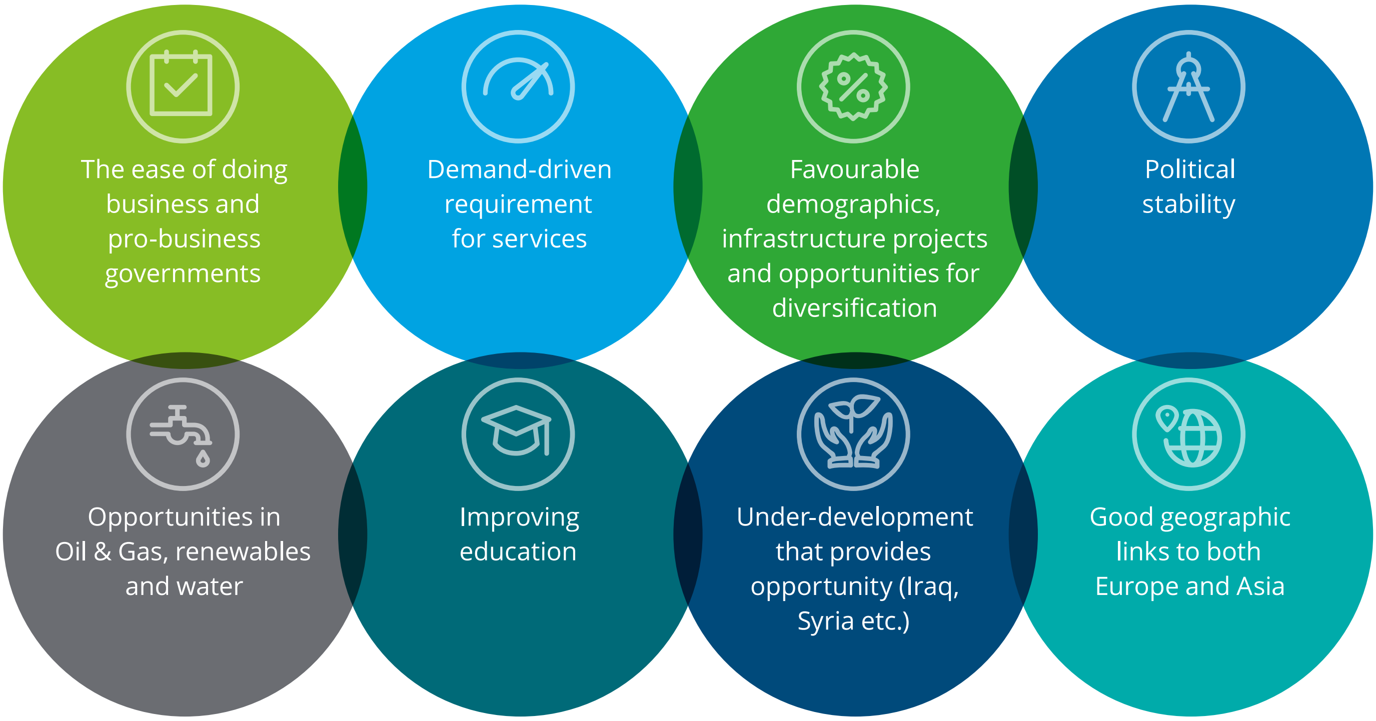
Question: To what extent is each of the following business strategies likely to be a priority for your business over the next 12 months?



From our discussions it is evident that, at all levels, family businesses remain positive on the growth prospects of the Middle East and will continue to be driven by a strong social and moral responsibility to invest there. Their local market is perceived by them to be lower risk. Another factor is that families want to leave a long-lasting and positive legacy in the region, so that their name will endure and be respected by future generations.

In the last 12 to 24 months, 65 per cent of the family businesses surveyed have invested most of their capital in their home country with the balance investing more heavily within the region, however outside their home country.

The following were listed by respondents as some of the key strengths of the MENA market that will drive its long-term growth:

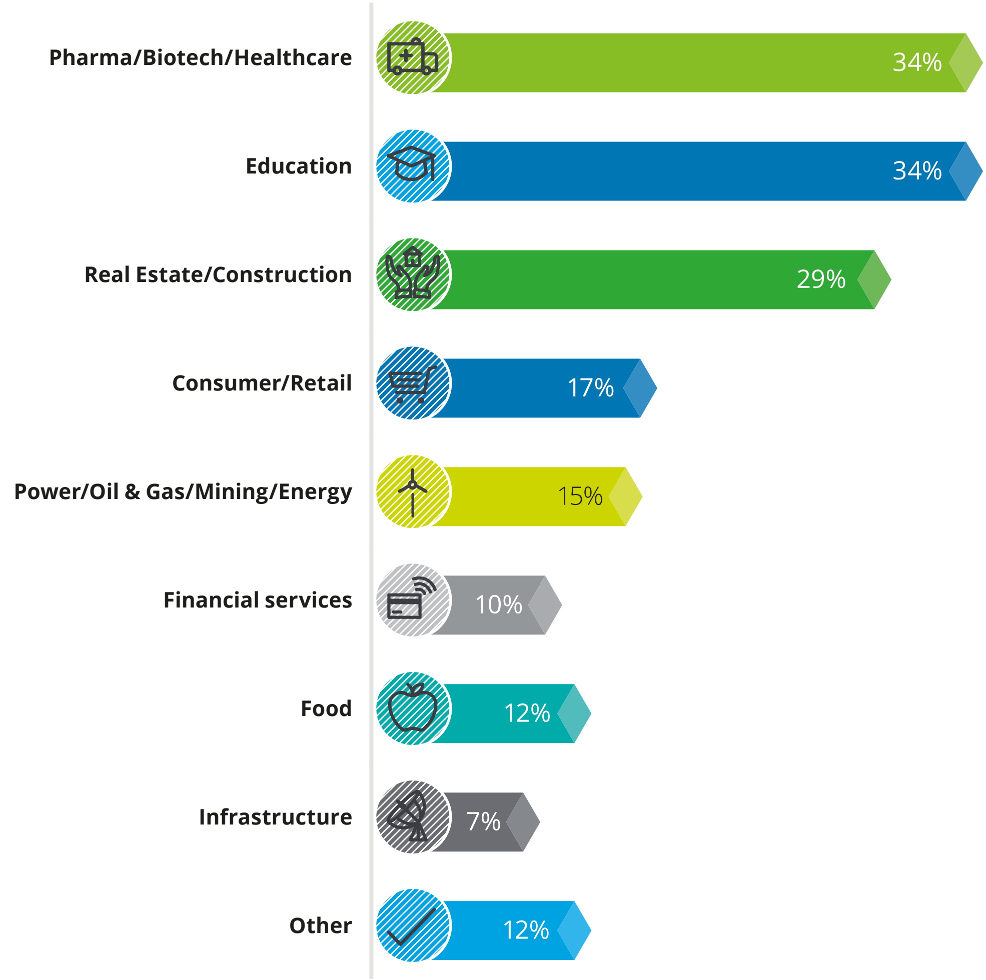


The areas in which respondents see the most deal activity in the near term are healthcare and education. Each of these sectors represented around 30 per cent of respondents' total asset base on average – pointing to a need for families to diversify their portfolios.

There are families who view the current less buoyant market conditions as an opportunity to enter neighbouring Gulf Cooperation Council (GCC) countries, where they currently have far fewer operations and hence less exposure. When entering these new markets, families are typically looking for smaller investments, that will complement an area of the business, where they already have a certain level of exposure, rather than investing in a new sector, which they perceive as a higher risk strategy.

Certain families are looking to expand further afield, by entering new emerging markets such as Turkey and Iran as they seek higher returns.

Question: In which industry sectors do you expect to see most deal activity over the next 12-24 months?*
Respondents were able to choose multiple answers



In the majority of instances, the more popular sectors highlighted above represented sectors which differed from their respective core divisions. This further reinforces the need for families to enhance their monitoring and measurement of both risk and return levels, as they continue to diversify into new sectors.

Conclusions of the survey

01 **Maintaining income and wealth of a growing family is paramount**
Families are growing in size as they move through the generations. Their challenge is to maintain the income and wealth that each family member has become accustomed to. In order to do that, higher returns are required.

02 **Improved governance is required to ensure strategies are aligned**
With a view to preserving family wealth, some of the larger families have improved governance and established more solid structures for their investment plan, making plain its objectives and processes. Frequent monitoring of capital across the group remains important, in order to ensure the risk and return characteristics of the portfolio are aligned to the overall strategy.

03 **Maturing markets make it harder to achieve returns**
At the same time however, the families acknowledge that regional markets are becoming increasingly mature, more globalised and more complex. This is making it harder for them to achieve the required returns.

04 **In the short term families will look to their existing businesses for growth**
Over the next 12-18 months the majority of family businesses will continue to drive growth from their existing businesses, as well as seeking strategically beneficial bolt-on M&A opportunities. They will likely do this in markets where they are already operating. Organic growth is expected to be driven largely by the internal restructuring of operations and cost rationalisation programmes.

05 **Family businesses remain positive on the growth prospects of the Middle East**
In the last two years most family businesses surveyed have invested almost all of their capital in their home country or in the wider region. Going forward these families will be driven by a strong social and moral responsibility to continue to invest close to home. The current market conditions are seen as an opportunity by some to enter neighbouring GCC countries, where they currently have far fewer operations and hence less exposure.

06 **External financing may be required to meet ongoing needs**
Families may generally need to consider taking on more risk, by investing in new and potentially unfamiliar sectors, or in new asset classes. Additionally, families are considering making acquisitions of larger more complex businesses, in order to meet their needs. One aspect of the requirement to increase risk, may involve resorting more to funding via external financing. Liquidity management is important at both investment and holding company level.

07 **Control is still key to many families**
Retaining the family's control of the group and ensuring its survival for future generations nevertheless, remains of paramount importance for families.

08 **Succession plans remove uncertainty**
Clear succession plans make sense, whatever the size of the family group. Our survey reveals that some families, and more often the smaller groups, do not have a clear plan. That creates uncertainty and is likely to make the business less decisive in markets where clear decision-making is essential.

How we can help you

Family business services

How we help MENA families and their businesses

Governance

- Devise multi generational governance strategies
- Draft and implement family protocols/ constitutions
- Offer mediation and conflict management/ resolution solutions
- Separate family from business
- Separate ownership from management
- Prepare and facilitate a family assembly
- Coach and offer development programs for next generation champions
- Assist patriarchs/ matriarchs pass the mantle
- Develop and implement a philanthropy strategy

The Business

- Business diagnosis, strategic reviews, and performance improvement plans
- Cash and working capital management
- Monitoring, reporting and benchmarking performance
- Reporting and accounting support
- Optimal capital structuring review
- Regulatory and compliance support
- Advise and assist with a VAT implementation strategy
- Conduct corporate engineering/ reengineering exercises

Deal Strategy

- Financial and commercial due diligence
- Valuation advice for M&A, restructuring, dispute and financial reporting purposes
- Real estate advisory including feasibility studies, valuation and capital raising
- IPO readiness
- Source and manage M&A transactions, including identifying and evaluating opportunities, negotiation and deal structuring, SPA support and capital raisings
- Debt advisory services including assessing sources of finance, capital raisings, negotiation support and structuring

Tax & Estate Planning

- Ring-fence and protect private assets such as real estate, bank accounts, jewellery and artwork
- Devise and implement an international tax strategy for the family to manage tax exposure in different jurisdictions
- Devise and implement an international legal strategy and security strategy
- Devise and implement a strategy to protect and/ or mitigate reputational risk
- Devise and implement a strategy to protect the family brand name

Scott Whalan
Partner
Deloitte Middle East
scwhalan@deloitte.com

Nick Beer
Director
Deloitte Middle East
nbeer@deloitte.com

Walid Chiniara
Partner
Deloitte Middle East
wchiniara@deloitte.com

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