Angel and Venture Capital Investing in MENA vs. Developed Countries

Funding gap highlighted by surge in Entrepreneurship

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Recession, Resurgence and Entrepreneurship

The tidal wave of the crisis that swept across the globe washed over the Middle East with no exception. In early 2008 the sentiment in the Middle East was positive with no fear of being hit by the crisis. Market attitudes remained buoyant as financial institutions in the region had little or no exposure to sub-prime credit products and credit derivatives, and because most Private Equity (PE) business in the region had been done almost with no leverage. However, the later parts of 2008 saw the decline in oil prices, nose dive in real estate rates, fall in tourism, and decline in consumption. Curtailment of risk appetites, banks restricting lending and drying up of liquidity in the region caused questioning of portfolio valuations which then faced downward pressure. The impact on the region was compounded by the under-developed nature of the financial regulatory environment.

In the aftermath of the crisis, the macroeconomic environment in the MENA improved; backed by oil price recovery, resurgence in consumption, existence of cash reserves and enactment of legislation for investors and investees. The financial sector achieved stability with the injection of funds into the banking systems by the regional sovereign wealth funds. There were public and private initiatives launched to boost the SMEs space, as they enable crucial aspects of economic diversification, job creation, and transformation of the society. With the overall improvement in the macroeconomic scenario, activity in the region soon began to shift towards an expanding service sector that catered to the needs of an increasingly affluent population.

In a region known historically for its commercial and mercantile prowess, entrepreneurial activity, which is more a process than an event, is rapidly proliferating. The increasingly affluent and young population of the region is a growing consumer market waiting to be catered to, resulting in products and services customized and “Arabized” for the region.

The Global Entrepreneurship Monitor (GEMs) 2009 report indicates the levels of entrepreneurial activity in the region. Early-Stage Entrepreneurial Activity (TEA) rate is a GEM’s measurement of the proportion of people aged 18-64 who are entrepreneurs or are owner-manager of a new business. A measurement of the entrepreneurial activity in 2009 reveals that Saudi Arabia had the lowest TEA rate at 4.7%. The United Arab Emirates (UAE) had a higher TEA at 13.3% and had a high proportion of improvement driven opportunity entrepreneurship in TEA at 79.0%, in line with its economic development.

There has been a significant reduction in the TEA rates for the United States (US) from 10.8% in 2008 to only 8.0% in 2009. Although cause for concern for the country, the numbers correspond with the decrease in Angel and Venture Capital investments made in the region during the same period. The United Kingdom (UK) has not seen significant changes in TEA from its levels in 2008. With UK ranking among the more mature markets in the EU, it has a mature Angel network characterized by increasing number of co-investment funds set up to close the equity gap and attract new Angels to the market.

The necessity driven entrepreneurship in both the US and the UK is on the higher side, reflecting the impact left behind by the recession.

Angel Investors and Venture Capital

Angel investors comprise of a mixture of investors ranging from informal investors, friends and family, individuals, group investors, and accredited and unaccredited investors. Angel investors are often entrepreneurs themselves who bring value to the invested company by way of mentoring and industry connections.

Venture Capital firms (VCs) provide “growth capital” for companies that are further along in their development. With the size and stage of funding being the predominant differentiator of VCs from Private Equity investments, VCs are often considered as a part of the Private Equity asset class, especially in emerging PE regions such as MENA, where there is limited coverage on the overall investment scenario.

Both Angel and VC investors are complementary and play a significant role in the overall development of enterprises. Their investment activity enables creation and expansion of enterprises, thereby generating jobs, as well as developing the economic value of the country.

MENA Overview

As of 2008, of the total 38 Venture Capital companies in the region, 16 with a total size of USD 700.0mn were actively investing into and targeting the early stage investment opportunities in the MENA region, covering seed, startup and expansion. Of 27 total funds looking to raise capital from 2008 to 2010, 12 funds had investment criteria of raising capital for VC or Growth Capital. However, these funds were not able to close their funds as quickly as expected, leading to a shortage of funds available for investing in these companies, coupled with a still lingering risk aversion from the crisis.

A review of early stage investments by region for the period 2005 to 2008 reveals that the UAE attracted most early stage investments with 37.0%; Jordan with 24.0%; Lebanon, Qatar and Saudi Arabia capturing 8.0% each; followed by Kuwait, Bahrain and other countries at 5.0% each. Early stage investments by sector for the same period revealed Financial Services as the most preferred investment space at high 44.0%, followed by Information Technology at 18.0% and Media at 13.0%.

Funding Gap

Informal/Angel Capital Review

As per the GEMs 2009 report, the total amount of Informal/Angel investment in a country is estimated using the average amount invested, the prevalence rate, and the population, correcting for the three year investment span. To compare the potential impact on a nation's economy, informal investment is expressed as a percentage of its GDP (2008 values).

With the UAE and Saudi Arabia forming the major chunk of early stage investments in the MENA, the amount of informal capital received by these countries as a percentage of their GDP is vastly different. Although the UAE is ahead of US and UK with 2.0% of GDP received as informal investment, Saudi Arabia falls behind Jordan and Lebanon with just 0.8% of informal capital.

However, informal capital requirement needs to be seen in relation to the money required to start a business. In countries having a higher start-up cost, funding availability plays an important role. Although Saudi Arabia is in the expensive quartile of countries for starting a business, it lags behind in the informal investment as a percent of GDP. However, UAE appears to be more balanced, being the 12th most expensive but ranks 13th on the amount of informal investment.

Seed/Angel Capital Investing in MENA

For the period 2005-08, 11 transactions with investments of less than USD 1.0mn were executed in the MENA region. With 16 funds catering to the needs of seed, start-up and early stage investment companies, there are very few funds that focus solely on the seed investment stage. Only ABAN (Arab Business Angels Network), FORSA, Building Block Fund, and KUV Capital target seed stage investments.

The years 2005 to 2008 saw both volume and size of the early stage transactions being very sporadic. The year 2005 recorded investment of USD 35.4mn in transactions under USD 5.0mn, with 2008 having recorded 8 early stage investments totaling to USD 6.7mn. With decreased appetite for risk, investors are typically attracted to later stage investments, creating an equity gap in the region that is waiting to be filled.

2008 MENA Seed/Angel Deal Flow Analysis

As per the ABAN study on Angel Investing in the MENA Region, of the sample 229 investment opportunities in 2008, there were a total of 140 relevant investment opportunities in the MENA region. Due to excess liquidity in the region, 89 deals (~40.0%) originated from developed nations such as the United States and the European region. An analysis of the deals reveal UAE accounting for 57.0% of the 140 deals, Lebanon at 10.0%, followed by Jordan at 9.0%, and Egypt and Saudi Arabia at 6.0% each. Of these deals, the sectors that attracted the most deals were the technology, retail, internet and media sectors, followed by the services and consultancy sector.

More than 73.0% of the companies required a funding of up to USD 1.0mn, translating into a total of USD 70.0mn, compared to the total amount invested for 2008 of USD 6.7mn. This situation clearly highlights the funding gap faced by young companies.

MENA Regional Characteristics

The closed nature of MENA markets lends opacity to investors, hampering growth of the enterprises. Alongside, the region is governed by private companies and SMEs who are reluctant to place funds with external investors. As a result, most deals in the region are sourced through private networks. For an investment environment to flourish and nurture enterprises, especially for companies seeking funding in the seed and startup stage, the establishment of professional networks that facilitate exchange of ideas and information is essential.

The emergence of Angel networks in the region alongside government initiatives is in the process of gradually building an innovation system and knowledge economy that supports the launch of startups. However, the growth of Venture Capital within the region is yet to happen as the attention is yet to move towards focusing on the growth financing needs of companies.

Recent Developments in MENA

- As of early 2009, the MENA region had only 3 Business Angel networks – ABAN, LBA, and Envestors.
- The World Business Angels Association (WBAA) was launched in April 2009 to promote the Angel market globally.
- Creation of the Qatar Business Angel Network by the Qatari government.
- In August 2010, Oasis 500, with investments from the King Abdullah II Fund for Development (KAFD), Jordanian Venture Capital firms, leading Jordanian technology companies, as well as Angel investors, had launched its operations by announcing that it is accepting applications for its entrepreneurship program with the goal of helping accelerate no less than 500 startups by 2015.
- There is also a new class of early-stage investors called the “Super Angels” has risen in the GCC region. This class of investors in known to bridge the gap between the traditionally risen seed money by the Angel investors and the large investments made by the VCs.

USA and Europe Angel and Venture Capital Markets

Angel Investing in the United States

The US being the most hit by the crisis, saw an overall rise in number of companies that received Angel funding in 2009, with the total dollar amount of investment falling by 8.3% over 2008 to USD 17.6bn. 57,225 entrepreneurial ventures received Angel funding in 2009, a reserved 3.1% increase from 2008 whereas the number of active investors in 2009 remained unchanged at 259,480 from 2008. A decline in the deal size by 11.1% as compared to 2008 indicates that while Angel investing activity has not significantly decreased, the overall commitment is of lesser dollars, backed by lower valuations and a cautious approach to investing.

Overall significant changes have been taking place in the critical seed and start-up stage investment landscape. Angel investment in the seed and start-up stage was 35.0% in 2009, a 10.0% y-o-y decrease. With the increase in interest in post-seed/start-up investing first round investments represented only 47.0% of 2009 Angel activity. The decline in interest is reflective of the difficult economy and little or no support for Angels, or the companies they invest in, from the various legislative initiatives enacted to stimulate the economy.

The trend of Angels moving away from seed and start-up capital is increasingly deepening the capital gap. With Angel investments contributing significantly to job growth, the lack of funding can cause serious damage to venture formation as well as job creation within the economy.

Angel Investing in Europe

Based on a study conducted by the European Business Angels Network (EBAN), the market consisted of 334 networks in 2009 with an estimated 75,000 Angels in the region. In 2008, the more mature Angel markets such as the United Kingdom (except Scotland), Sweden, Germany, Belgium, Italy and the Netherlands experienced a decrease in the number of Angel networks. The fall in the number of networks is largely attributed to the gradual professionalization of the industry, where the less performing networks cease to operate after the first few years.

According to the EBAN Statistics Compendium 2009 study, business Angels in the European region have been going strong in spite of the financial and economic downturn and are known to play a crucial role in financing high-growth, innovative start-ups.

As a result of the current challenges and the importance of nurturing investee companies, Angel investors have been focusing on local deal flow. This has led to a decrease in the number of investments outside of the network's region/country.

Market Trends in United Kingdom

Based on a comparison in the investment activity in the UK market (BBAA Networks and LINC Scotland) between 2000-01 and 2008-09, the investment activity has increased by 41.0% from 217 to 307. The total deal value has recorded an increase of 148.0% to £123.2mn while the amount invested by Angels has risen by 109.0% to £62.0mn during the same period. The market has also seen a significantly huge shift in co-investment leading to a sharp fall in the number of investments with single Angel, which dropped from 73.0% to 39.0%.

Venture Capital

Venture Capital investment in 2008 was down 8.0% in the United States and 12.8% in Europe compared with 2007, but both were still higher than 2006 levels. In 2008, more Venture Capital in value terms was invested in seed, start-up, and early stage companies in the United States than in Europe. The number of companies that received VC investment in the US was much smaller compared to Europe, lending the average investment size to be larger.

This indicates that VCs in the United States are not only more selective than their counterparts in picking portfolio companies but they also invest far more money per deal and per company. The emerging trend with interest towards post seed stage funding is not favorable, especially in an economy in need of job creation and resurgence in economic stability.

Conclusion - Positioning of MENA

The oil rich MENA region is different in several aspects from the developed regions of the United States and Europe and is characterized by its distinctive “Arabized” products and services. Although the region need not emulate the growth patterns of other countries, in the initial stages of planning a roadmap for growth and understanding of the path of these developed markets is definitely helpful.

With the MENA shifting its base from being a family business to a corporate environment, the comparison to the developed markets of US and Europe brings to light the need for an organized and focused development cells or ecosystem for nurturing enterprises and ventures in the region. These development cells or ecosystems are akin to those in the land of entrepreneurship where support systems are provided to entrepreneurs with the investment hubs built around them – such as the Silicon Valley. The existence and growth of Angel networks bring about the creation of centers of knowledge which foster mentoring and allow for networking on a local as well as regional level. The current planned and strategized launch of regional networks across the region focused on creating an ecosystem of investors, incubators and accelerators for entrepreneurs should make a gradual impact on a region. It is expected that with the emergence of Angel networks in the region, the current lack of transparency and reliable information in the region should be dispelled.

Angel investors bring with them not just seed capital, but also industry experience that translates to mentoring the invested company. With the global stories of Google, Apple, Amazon and Body Shop being commonplace, the entrepreneurial stories of Orascom, Maktoob and Rubicon among other, have drawn global attention to the potential in the MENA. Earlier in the year, the European Venture Capital arm of U.S. chip maker Intel announced its plans to double its investment in the Middle East as well as Eastern Europe and Africa, shifting its focus from Western Europe. Among those tapped to help is Silicon Valley-based TechWadi, an organization founded four years ago to link up Arabs working in the tech economy. TechWadi 100 plans to identify 100 Arabic mentors in the U.S., who will work with startups in the Middle East.

Entrepreneurs bring about innovation and job creation, speeding up structural changes in the economy and challenging established incumbents in a region otherwise governed by the state. However, the pace of regulatory environment has to keep up pace with the fast economic growth taking place. While the MENA ranks high on generous tax regime, other regulations that make the region more investor friendly are important for the development of Angel and VC investment environment. Economies in the region having reduced or abolished the minimum capital requirement for starting a limited liability company, it may in turn provide an important stimulus for the region’s Venture Capital industry. Support by way of government initiatives and policies; existence of stable macroeconomics; favorable legal and regulatory conditions; adherence to corporate governance and transparency in transactions; creation of a knowledge intensive environment and a transparent market environment supported by research and knowledge creation will enable the overall development of the region.