

## THE FINANCING GAP

# Harnessing capital

Capital markets can be used to provide equity to allow mid-sized companies to expand.

# markets to support

But to get there, regulators need to make capital markets' rules more flexible both for companies and investors.

# Arab entrepreneurs

BY ALISSA AMICO

**T**he political and economic divides of the Middle East and North Africa (MENA) cut through the region across multiple lines of oil importing and exporting, capital exporting and importing, labour scarce and labour abundant countries. Though possessing complementary factors of production, the region has some of the lowest rates of economic integration, as intra-regional trade stands at only 10 per cent, having already tripled between 2000-2005. The integration of labour markets remains negligible as the Gulf, but also other countries in the region, prefer to import outside labourers, even as ongoing conflicts in the region are resulting in significant migratory flows.

The theme that has dominated both policy discussions in Washington and coffee shop talks in Cairo is unemployment, estimated by the World Bank at 22 per cent for young males and 39 per cent for young females. While differences across the region exist, today unemployment is considered the primary economic

plague of the region and one that is common to the entire region. Almost five years after the first revolution in the recent history of the Arab world swept in a new regime in Tunisia, few creative solutions have been put forth and unsurprisingly, unemployment rates remain stubbornly high, the highest in the world for some groups.

At the same time, the rabbit is out of the bag: few experts on the Arab world disagree about the root causes of unemployment in the region, pointing to the dominant role of the state in the economy and obstacles standing in the way of entrepreneurs, notably lack of corporate finance, especially for mid-size, growth companies. One survey by the World Economic Forum suggests that the most visibly absent piece from the Arab world's financing puzzle—the missing middle that also characterises the social fabric of the region—is financing to mid-size growth companies valued between half and eight million USD.

While estimates for the funding gap vary, it is clear that bank credit, so far the dominant source of formal corporate finance in the region, is neither an appropriate nor a sufficient mechanism for supporting entrepreneurship. In contrast to bank loans which

in emerging markets have a maturity of 2.8 years according to a Group of Thirty report, equity capital cannot be easily withdrawn. It does not require collateral and it can be used to finance corporate research and development activities: between 2005-2010 retained earnings financed 66 per cent of corporate investments in developed markets. Despite a range of initiatives in the region, all generally aimed to channel credit to SMEs, innovation and entrepreneurship levels have not picked up.

The World Bank estimates that the Middle East and North Africa region has the lowest rate of young companies globally, apart from Sub-Saharan Africa. Across the region, state-owned enterprises and large family conglomerates, often protected by a variety of formal and informal barriers, remain the locomotive of the corporate sector. In the current constellation, they are not faced with a “new generation” of growth companies who could challenge their business model as the latter are constrained in their development by short-term financing. Financing is often based on collateral in the form of fixed assets, which is inconsistent with the emerging corporate reality where assets are increasingly intangible and hence difficult to pledge as collateral.

While stock exchanges and securities regulators in the region have revealed a formidable arsenal of new regulations and incentives for firms to access capital markets, the focus so far has generally been on growing markets through privatisations and disposal of stakes in family companies, an alternative which founders of most large family business in the region have contemplated with scepticism. While the 2005-2010 period saw close to 1,500 initial public offerings (IPOs) in the region, the subsequent five years have seen only 200. Few of these were new enterprises seeking equity financing through capital markets.

While opportunities for development are clearly significant, capital markets are currently not being harnessed as a vehicle for financing growth companies in the region. Facing challenges in developing its capital market which today has only 10 listed firms, the Lebanese Central Bank has recently issued a circular providing incentives for banks to invest in high technology ventures, effectively side-stepping the capital market which remains dormant. Markets in other countries including Algeria are also at very early stages of development.

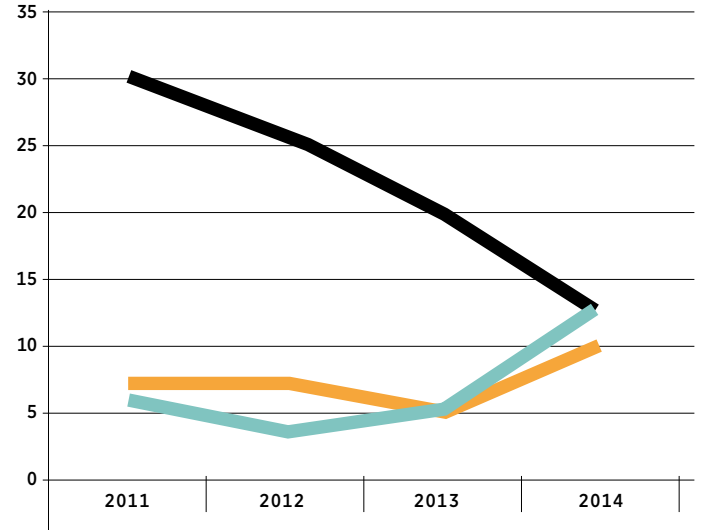
Experiments with financing growth companies through capital markets have shown disappointing results across the region. The first dedicated SME exchange in the Arab world, NILEX, which launched in Egypt in 2007, currently has less than 25 listed companies; the Venture Exchange in Qatar, a more recent initiative, has so far not attracted any listings. The reasons for this apathy

are certainly diverse, but arguments that focus on purely financial factors such as the cost of listing are not convincing. Fiscal incentives provided to Egyptian companies to list in the late 1990s also proved to be a failed experiment, as firms attracted by these incentives were found to be illiquid and lacking transparency: 800 of them were subsequently delisted.

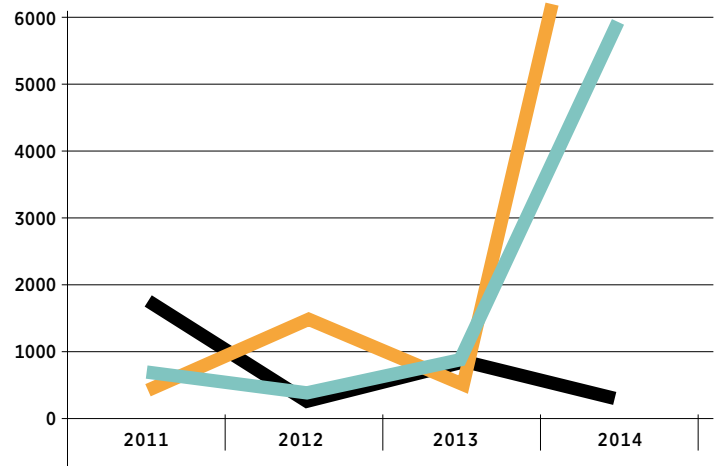
Perhaps even more alarmingly, several markets in the region, notably Kuwait, are currently seeing a surge of voluntary de-listings, with over 10 per cent of the listed companies announcing their decision to de-list

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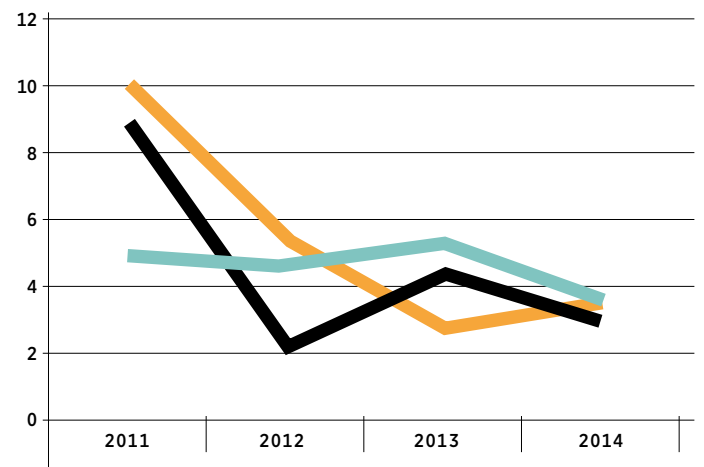
TURKEY — SAUDI ARABIA — UNITED ARAB EMIRATES —  
**NUMBER OF INITIAL PUBLIC LISTINGS**



**IPO PROCEEDS (MILLION USD)**



**GDP GROWTH (ANNUAL %)**





Photograph: Stian Overdahl

Saudi Arabia has seen the highest proceeds from new listings over the 2010-2015 period, while Turkey had the greatest number of IPOs.

since 2014. Simultaneously, a number of Arab blue chip companies have decided to raise capital on the London Stock Exchange, which currently has approximately 30 listed firms from across MENA. These figures demonstrate that despite efforts of regulators and exchanges, the use of capital markets to support real innovation and risk taking activity by private entrepreneurs has not taken off.

The paradox is that while the region, or at least the GCC countries, are capital abundant, this capital is not flowing to exchanges to finance corporate growth, innovation and by extension, employment creation, the latter being the most significant and recognised economic challenge. While there have been successful recent experiments in raising capital in the region, for instance the IPO of the National Commercial Bank in Saudi Arabia in 2014, these transactions are generally not channelling capital to the real economy, with the result being that across the region banks dominate capital markets.

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#### IPOs IN THE MENA REGION (2010-2015)

COUNTRY	NUMBER OF ISSUES	PROCEEDS (\$MILLION)
SAUDI ARABIA	33	14,464
UAE	31	9,392
QATAR	4	4,469
TURKEY	92	3,305
EGYPT	15	1,870
OMAN	7	524
MOROCCO	7	462
KUWAIT	5	332
JORDAN	6	38
<b>TOTAL</b>	<b>200</b>	<b>34,858</b>

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In emerging markets, the amount of equity capital raised through IPOs more than doubled to \$65 billion in 2008-2014, according to recent OECD estimates. Smaller companies from emerging markets have actually reached significant levels of equity financing over the past seven years, which indicates that there are models and mechanisms aside from introducing secondary tiers for SMEs that have worked in other markets.

Indeed, introducing secondary listing tiers or growth markets has been a recipe for success in just a handful of markets, such as NASDAQ and London's AIM, even though efforts to replicate these models have been made globally, argues Erik Vermeulen, a Dutch academic in his recent analysis of IPO markets.

As a result, the amount of capital raised for growth companies has seen a remarkable decline, representing only 11 per cent of all equity raised in developed markets. While the reasons for the failure of developed markets to attract growth companies to list are generally irrelevant to the MENA region given that the market infrastructure is entirely different—with no privately owned stock exchanges, no alternative trading platforms and few exchange traded funds—the lessons extracted from these experiences are certainly informative for policy makers in the region.

Supporting growth companies through public equity markets cannot be predicated, as it has so far been attempted in the region, on merely relaxing existing listing and governance standards in the hope that this will entice entrepreneurs. Instead, the mechanisms for attracting growth companies must allow for the protection of the interests of founding shareholders, as it has been done in some recent high profile IPOs such as Facebook, while at the same time ensuring sufficient corporate transparency to prospective shareholders, an issue that both domestic and foreign investors in the region consider of priority. Some regulators in the region have already moved in this direction, for example the United Arab Emirates, by reducing the requirement to IPO 30 per cent of the capital when previously it was 55 per cent.

Other creative solutions are clearly in demand. MENA exchanges could create specialised tiers open to qualified investors where shares of growth companies could trade as it has already been done in markets such as Hong Kong, which launched a Growth Enterprise Market for professional and informed investors. One of the reasons for limiting access to qualified investors is that most MENA markets are currently dominated by retail investors. These investors, while being relatively minor owners of listed equity, dominate trading activity which results in significant market volatility. This is because their trading is often rumour-driven and reactionary to macroeconomic developments such as oil price fluctuations which are unrelated to corporate fundamentals of most listed companies. According to recent statistics released by the Tadawul, the Saudi Stock Exchange, while local retail investors including high net worth individuals owned 12.6 per cent of the market, they accounted for 82.3 per cent of the trading activity as of August 2015.

In tandem, improving the scope and the quality of participation of existing, primarily domestic sources of institutional investment in the region is crucial to deepen equity markets. Traditional institutional investors such as pension and investment funds as well as insurance companies which account for the vast majority of ownership in developed OECD markets (60 per cent in US and 80 per cent in Japan), are minor owners of listed equity in the region due to the generally low levels of development of these sectors, but also due to the regulatory limits placed on exposure of pension funds and insurance companies to equity markets. In Egypt for instance, any pension fund's exposure to equity or mutual funds cannot exceed 10 per cent of their investments, a low threshold compared to developed OECD markets which either do not limit or place higher limits on equity investments.

Improving the quality of participation of existing institutional investors, notably sovereign investors which currently account for close to 40 per cent of the market capitalisation in the region, can be seen as a short term, tangible step towards improving the quality of investor engagement. While these investors have historically acted as passive blockholders, with the expansion of their holdings in capital markets of the region, they possess both the influence over their portfolio companies and a considerable knowledge of local markets to engage with boards and management of these firms as long-term investors. Their engagement and efforts to improve the quality of capital markets in the region can facilitate the entry of foreign institutional capital in the region, which is relatively low in all countries except for Turkey.

In particular, insofar as a number of sovereign investors have mandates to develop particular sectors, incubating and investing in these firms through the capital market is a logical extension of their mandates and can help anchor the development of strategic sectors such as healthcare where private equity financing is already deployed. OECD's recent research on growth companies highlights that in developed markets, 43 per cent of all equity capital raised through smaller IPOs between 2000-2014 went to high technology sectors, double that of emerging markets. Herein lies the opportunity. In short, the Arab world needs its Facebook or Alibaba IPO not only to stimulate capital markets and increase financial intermediation through institutional investors, but to channel risk capital to a new generation of enterprises that could contribute to economic diversification, innovation and employment creation in high value add sectors.

The diagnosis and the solutions are clear enough to admit that the rabbit is out of the bag. In Lewis Carroll's famous book *Alice in Wonderland* the rabbit appears at the start of the novel exclaiming “Oh dear! Oh dear! I shall be too late!” It is not too late to examine how capital markets in the region can be put at the service of growth companies and the creation of employment opportunities. It is only when the incentives and measures for entrepreneurial success are clear and when capital markets can act as an avenue to supply additional capital or provide an exit option, that university graduates will stop perceiving government employment as the light at the end of the tunnel. •

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