

Beyond Covid-19:

Reinvigorating the economy in the MENA region by focusing on mid-caps and SMEs

In this Q&A briefing, co-heads of Allen & Overy's Middle East Asset Management and Financial Services Regulatory practice Nick Smith and Jodi Norman, and Kamar Jaffer, a counsel in that practice, are joined by Taimoor Labib, founding partner at Affirma Capital and Head of MENA and Chairman of Africa, to examine the impact of the pandemic on the region's midcaps and SMEs.

They explore how governments in different countries have reacted, the stimulus measures in place across the MENA region, the wider trends and challenges they are seeing in capital raising and also how greater co-ordination and collaboration among financial services players – in particular, banks, institutional investors, private equity funds, FinTechs and equity crowdfunding platforms – can help to improve the outlook of these critically important businesses.

How are mid-caps and SMEs in the MENA region faring in the current Covid -19 circumstances?

This is truly a broad-based global crisis. During the global financial crisis, there was a global credit squeeze and it hit nearly everyone, but it was limited and relatively contained. This is broader – hitting global supply chains, supply and demand and it is going to be defined by consumers downsizing across products and pulling back on discretionary spending across all sectors.

In the long-run nearly every SME and mid-cap company will be hit. When we look at the impact, we look at this across two broad categories. The first one is business impact and the second one is liquidity impact. When we think about business impact, we should consider retail and F&B – important sectors in the UAE, GCC and MENA regions. Restaurants are down 30% to 80% depending on the type of restaurant and if they have delivery and even those that are working their margins have been hit tremendously. The second bracket will be

retailers of discretionary goods such as furniture and electronics. Those have been heavily impacted. The third bracket includes grocery stores and chains, some are positive from a revenue perspective, but margins are definitely down. Across the F&B and retail space, everyone's going to be hit and 90% will be hit negatively.

In terms of the liquidity impact, this is going to impact the SMEs and mid-caps because they do not have the size and skill of larger companies. Even in the best of times they have limited cash reserves, limited access to private funding and their teams are not as transformational and are not as sophisticated as larger counterparts. Even companies that were very well-run before, are going to need help. It's going to need all of us to come together and help each other get out of this.

– Taimoor Labib

“The UAE, Saudi Arabia and Egypt are commended for the measures they have implemented in regards to stimulus packages and have generally been rolled out faster than global counterparts. There has been an impressive amount of quantum as a percentage of GDP allocated to these measures.”

What is going on with mid-caps and SMEs in the MENA region today?

SMEs are an important pillar in our economy. They represent 98% of companies operating in the UAE amounting to over 50% of the non-oil GDP. They play a pivotal role in people's lives. They employ more than 90% of the private workforce. SMEs and mid-caps are a catalyst for economic growth and they serve as a basis for job creation in a region where we see a young population. SMEs contribute to product innovation and they enhance the competitive landscape. They have been disproportionately affected by the supply and demand shock

and cash flow constraints in the current crisis. Some SMEs in telemedicine and ecommerce are doing well, whereas others in F&B, hospitality and retail are being hit harder. F&B employs 10% of the Dubai population.

SMEs are key to the economy and they affect other sectors such as the financial sector, which is already under strain by non-performing loans in their portfolios.

– Kamar Jaffer

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Are there any stimulus measures in place to support mid-caps and SMEs in the MENA region?

As for Covid-19 considerations, there are public sector policies in place across the MENA region to support SME financing. Bank lending, whether to the firm itself, or to business owners, remains the present form of external SME financing in the region. Existing policies include co-financing or risk mitigation facilities, direct lending schemes, tax subsidies and interest rate caps. Over the last ten years, the focus upon SME support policies has largely shifted from broad-based counter-cyclical support (following the 2008 financial crisis) to more targeted policies in recent years. This approach is aimed at promoting innovation and start-ups, however there has been a renewed focus on these initiatives as a result of the Covid-19 pandemic.

Governments have been quick to respond with a range of policy initiatives globally. The responses have typically taken the following sequence of measures;

- 1) Health measures and information to SMEs on how to adhere to them.
- 2) Measures to address liquidity by deferring payments.
- 3) Measures to supply extra and easily available credit to strengthen SMEs resilience.
- 4) Measures to avoid or mitigate the consequences of unorganised layoffs by extending possibilities for temporary redundancies and wage subsidies.
- 5) Structural policies.

– Jodi Norman

How have different countries reacted?

There are different types of measures that have been taken:



1) Employment – Several countries have introduced measures related to shortening working time, temporary layoffs and sick leave and some of these measures are targeted directly at SMEs. Governments are providing wage and income support to employees who are temporarily laid off in return for companies safe guarding employment.



2) Liquidity restraints – Measures have been designed to ease liquidity constraints. Many countries have introduced measures towards deferral of tax, social security payments, debt payments and rent and utility payments. Some countries have implemented tax relief or moratorium debt repayments.



3) Working capital – Several countries have extended or simplified the provisional loan guarantees to enable commercial banks to expand lending to SMEs. Some countries have stepped up direct lending to SMEs through public institutions.



4) Subsidies – There are schemes to grant subsidies to SMEs and companies have bridged the drop in revenues. Increasingly, countries are putting in place structural policies to help SMEs adopt new working methods, including the use of digital technologies. This enables them to find new markets and sales channels to continue operations under the prevailing containment measures.

– Jodi Norman

How have we reacted within the MENA region?

Regionally, there are various stimulus packages being rolled out. In the UAE, the Central Bank has put in place the targeted economic support scheme. The Central Bank is directing banks and other financial companies to offer payment holidays under existing facilities until the end of the year, and those holidays extend to the principal amount and to interest repayments. They are recommending that banks and other financial companies provide additional financing including working capital and new credit lines at reduced rates.

These initiatives are available to the private sector, SMEs and individuals effected by Covid-19.

Saudi Arabia has rolled out similar stimulus packages. The Saudi Central Bank has announced a private sector financing support program with a value of approx. 50bn Saudi Riyals, including 30bn being deposited with Saudi banks in return for a six-month deferment on payment obligations owed by SMEs to those institutions.

– Jodi Norman

What else has been happening in the MENA region?

The UAE, Saudi Arabia and Egypt are commended for the measures they have implemented in regards to stimulus packages and have generally been rolled out faster than global counterparts. There has been an impressive amount of quantum as a percentage of GDP allocated to these measures.

There has to be considerations around which companies should be targeted for support and how the support will be provided. This questions how you define a well-run business pre-Covid-19 and how the business will perform post-Covid-19. The government will also likely consider which

sectors are strategic. Many countries will focus on their strategic sectors and no-one wants to be at the mercy of another country's supply chain. Pharmaceuticals are now coming back full circle in many countries in the region, this will allow for better control of supply chains.

It is important for SMEs and mid-caps to consider the correct capital structure for them. They should ask themselves questions such as: can you support more debt when you require equity? And, what is your three to five year plan for your business and how much capital will you require?

– Taimoor Labib

What are the biggest challenges that banks are facing now?

This is certainly a critical part of the stimulus solution and a very important part of traditional financing. Large commercial banks are accustomed to handling traditional loans with large companies. The typical mid-cap business will be a challenge for some banks and their credit committees. It will be

challenging for some mid-caps to get their quarterly reports to the bank and monitoring their KPIs will be difficult. Banks may have to be incentivised to lend to these smaller companies than they would typically allocate capital to.

– Taimoor Labib

What is the role of private equity firms in regards to mid-caps and SMEs and what can they bring to the table?

Private equity firms can offer a large amount of help in the current crisis. They will provide equity in the balance sheet rather than debt and will allow companies to grow in the short, medium and long term without the need to pay back interest nor take on additional debt burden. From a capital balance sheet perspective, private equity is more suited to mid-caps and SMEs.

Once a private equity investor joins the board working closely with the founders and management team, they can help optimise liquidity, introduce KPIs and capital structure. They can help attract senior talent, growth and strategy. Many companies, with or without an equity injection, are going to have to be more creative – something that private equity will do.

Private equity's ability to help attract senior talent is critical, as mid-cap companies will have to move away from being a one-man/one-woman show and get the proper c-suite of executives to run the business. When clients see that a third party has invested equity, they become more comfortable with business plans.

Some funding that the governments are doing with banks can be diversified. Private equity firms can help companies with strong business models. The majority of stimulus will still be through banks but there are other avenues such as private equity. The benefit of this is that the funds will be available sooner to the mid-caps and SMEs. This can also be monitored to make sure the money is going to the right places.

As an example, we are an investor in Fine Hygienic Tissues, one of the leading regional tissue maker. It developed a mask product very quickly once the crisis began.

If we were not a private investor in Fine Hygienic Tissues, this company would not be as big, would not be as defensible and might not be able to continue to operate in the current climate.

– Taimoor Labib

“The UAE, Saudi Arabia and Egypt have strong underlying economies and with the right partners on board, there will be winners at the other end of the crisis.”

What are the trends related to capital raising?

Banks will be retrenching from lending to SMEs and mid-caps. They will be focusing on their portfolios so SMEs and mid-caps are more diverse. They have different business models. They are at different stages of their development and they have different financial structures.

In terms of funding, there will be no “one-size fits all” and SMEs will want to be able to tap into a different range of funding options. This gives an opportunity to institutional investors. There are risks and therefore SMEs and mid-caps should be screened to help mitigate these risks. Asking the right questions during the due diligence process is important, as is standardising some of the investment documentation and taking the necessary contractual protections. Legal-tech platforms can streamline the investment process.

Speed and agility will be the name of the game here for investors. The general rule should be for experienced private equity, credit and venture capital firms to play and support companies through this phase of the crisis and beyond. It is important to provide strategic advice in regards to potential acquisitions, consolidation, and synergies, taking in to account governance and talent management.

Greater collaboration and co-ordination amongst institutional players such as public institutions, banks and funds in our community is needed to create dedicated SME funds, co-investment programmes or funding platforms. Now is the time to press on the accelerator and create that ecosystem.

– Kamar Jaffer

What should be done from a regulatory perspective to assist with the implementation of funding strategies?

Feedback from stakeholders suggests that SME financing trends are largely driven by macro-economic conditions and factors other than financial regulation. These factors include the public policies in place to address SME financing constraints and the prevailing financial conditions. For example, the lower interest rates we have been experiencing recently. Banks are still the primary external source of SME financing, the regulatory reforms that have been most relevant to date are the Basel III capital liquidity requirements. The data needs to be closely monitored to understand the impacts on SME lending. The implementation of the remaining Basel III standard, which was due to come in to force in January 2022 has been deferred for one year. This is one of a number of global measures to provide banks and supervisors additional operational capacity to respond to the global financial and economic impact caused by Covid-19.

The impact of financial reforms and the provisions of SME financing is largely dependent on the degree of substitution between bank and non-bank sources. The role of FinTech credit platforms and other innovations in SME financing are relevant here. Fin Tech credit platforms, including peer to peer and marketplace lending are growing since the financial crisis as they are catering to pent-up demand for unsecured borrowing from individuals and SMEs (particularly micro-SMEs and those who have credit history).

In order to create market share, Fin Tech lenders have sought to raise funds from institutional investors such as pension funds, asset managers and other financial institutions including banks. There is a real opportunity for different market participants to co-ordinate, collaborate, and work together.

Other initiatives include access to public capital markets for SMEs. It is not common and that partly reflects the higher cost of tapping those markets for SMEs and the capacity of information relative to large firms. There have been a number of technical regulatory solutions, for example, seeking to facilitate access of SMEs to the capital market. Another area worthy of consideration is equity crowd-funding. Equity crowd-funding is a recent innovative source of SME finance and allows investors to take an equity stake in small firms. This form of finance has grown in the UK and to a lesser extent in the U.S. and The People’s Republic of China. This is an area that can assist in private equity intervention.

– Jodi Norman

“Every business is different and the good thing about private equity is it can offer bespoke solutions that work with the investing company to resolve their financing, capital and structural issues. There will be opportunities to grow after the crisis and success will come out of this.”

One of the biggest challenges for mid-caps and SMEs is how to employ what financing there is to grow and create value. What else should be considered here?

Every business is different and the good thing about private equity is it can offer bespoke solutions that work with the investing company to resolve their financing, capital and structural issues.

There will be opportunities to grow after the crisis and success will come out of this. There will be much less competition and there are well-capitalised companies with good visions and strategies. Access to private capital helps.

Historically, many companies who have survived a crisis have come out stronger.

The UAE, Saudi Arabia and Egypt have strong underlying economies and with the right partners on board, there will be winners at the other end of the crisis.

– Taimoor Labib

What else should mid-caps and SMEs continue to consider?

They should continue to focus on the need to accelerate the sustainable structural solutions that MENA countries have been looking at and continue the development of capital markets for access by SMEs and mid-caps and improvement of corporate governance standards. Credit registries and bureaus could continue to give further information to investors, banks and funds, to help them assess the risk profile and make informed investment decisions on such entities.

It will be beneficial to have further improvements in the collateral regime, especially for movable assets for financing solutions. Finally, continuing to work on insolvency regimes and creditor rights will help with specific measures to enable SMEs to continue to operate.

– Kamar Jaffer

The consideration of additional targeted stimulus measures for MENA region's mid-caps and SMEs would give the potential for greater co-ordination and collaboration between public institutions funds as well as banks. The key players should consider taking the opportunity now, during this period, to connect on this important topic.

This Q&A briefing is based on the conversation held between Nick Smith, Jodi Norman, Kamar Jaffer and Taimoor Labib in May 2020.



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