COUNTRY COMPARATIVE GUIDES 2024

The Legal 500 Country Comparative Guides

Egypt

PRIVATE EQUITY

Contributor

Alliance Law Firm

Omar Farid

Partner, Capital Markets and M&A | ofarid@alfegypt.com

Hagar Mohamed

Senior Associate, M&A | hmohamed@alfegypt.com

Ahmed Rady

Associate, M&A | arady@alfegypt.com

This country-specific Q&A provides an overview of private equity laws and regulations applicable in Egypt.

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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

Despite the challenges facing the region, Egypt has witnessed considerable number of M&A transactions, Bloomberg has reported 275 deals related to the Egyptian market over the last 24 months. However, the economic challenges in the region and high inflation have affected the transactions' value and target companies' valuations. We note that only 60 transactions have reported a value exceeding USD 20 million.

Most of the transactions have involved financial sponsors, specifically on the buy side. For the M&A transactions, they were mainly led by investment and sovereign funds from the GCC, namely the United Arab Emirates and Saudi Arabia. As for the equity fundraising transactions, the lead investors were mainly private equity and venture capital funds based in Europe and the USA. On the sell side, the key transactions were mainly driven by the government's privatization program, with the aim to attract foreign investment and boost the private sector by selling state-ownerships in various companies, whether publicly listed companies or private companies.

The trade sellers were mainly on the sell side, as a considerable number of the business in Egypt are owned by family offices.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

While most financial sponsors are not involved in the day-to-day operations of the target, the financial sponsors would aim to limit the business warranties and focus on fundamental warranties. Also, they will ultimately limit liabilities towards the purchaser post-closing and limit any common surviving risks or exposures. This will include collecting the majority (if not all) of the purchase price at closing without granting the purchaser the right to retain an amount of the purchase price as collateral for potential indemnity claims. Furthermore, they will offer a short window for indemnity claims. On the contrary, trade sellers would commonly provide extensive business warranties, while mitigating their exposure through the disclosure letter (schedule of exclusions).

As for the pricing and the transaction valuation, financial sponsors will typically favor the use of locked box mechanisms for determining the consideration, thereby fixing the purchase price based on a predetermined financial snapshot of the target company, as it provides certainty and transparency regarding the value of the business at the time of the snapshot and aligns interests. On the other hand, when acquiring a business from a trade seller, the prevailing practice leans towards closing accounts mechanism.

In case the financial sponsor is not fully divesting, the financial sponsor will mainly aim to set terms that guarantee achieving a higher return on the remaining interest in the target. Nevertheless, the financial sponsor would ensure an exit path through a put option clause or a clear agreement on the exit path that is not limited to listing the target company. On the other hand, trade sellers will aim to be in control of the day-to-day management as well as strategic decisions taking.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The process for effecting the transfer of shares and the transfer taxes payable in Egypt depend on whether the shares are listed or unlisted, and whether the target company is a joint stock company or a limited liability company.

For joint stock companies whether listed or not, the transfer requires the appointment of a licensed broker and licensed custodian to execute the transaction before the Egyptian Exchange (EGX). The process will mainly require submitting sell order from the seller and buy order from the buyer, after completion the transfer shall be registered with the target company clearing house (commonly Misr Clearing Company for Central Depository and Registry).

The process will require that the consideration is deposited with the appointed broker in Egypt, unless an exemption from the consideration deposit is granted by the Financial Regulatory Authority (FRA). The FRA approval is also required if the transaction consideration exceeds 20 million Egyptian pounds.

In case of a listed shares, the transfer can be perfected through open market transactions or block trade or by submitting a tender offer, whether voluntary or mandatory, which depends on exceeding certain thresholds as stated by the Capital Markets Law no.95 of 1992 (CML).

As for limited liability companies, it only requires a shareholder's resolution approving the transfer as well as waiver of the right of first refusal, which shall be further ratified before the Companies Authority (General Authority For Investment) and notarized before the public notary.

For joint stock companies, stamp tax apply on the transfer of shares, whether listed or unlisted, and are due at the time of the transaction. The applicable rate varies based on the percentage of the share capital it applies on the seller and buyer. On the other hand, capital gain taxes also apply on sale of shares transactions generating profits to the seller, the rate depends on whether or not the listed or unlisted, being 10% vs 22.5%.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

Using a special purpose vehicle (SPV) may raise some concerns for the sellers of a target company, such as the credibility and solvency of the SPV, the identity and control of the ultimate beneficial owners of the SPV, and the potential disputes or defaults during or after the transaction closing. Therefore, the sellers may require some comfort measures from the financial sponsor to mitigate these risks and ensure a smooth and successful transaction. By providing these comfort measures, the financial sponsor can demonstrate good faith and credibility to the sellers and increase the likelihood of closing the deal. Some of the common comfort measures that the sellers may request from the financial sponsor are:

- An equity commitment letter furnished from the financial sponsor to the SPV or the sellers, depending on the transaction structure, committing to providing the necessary funding for the acquisition, provided that certain conditions are met.
- An ultimate beneficiary owner's (UBO) confirmation, disclosing the identity and ownership structure of the UBOs of the SPV and any changes that may occur during or after the transaction.
- A break-up fee that the financial sponsor agrees to pay to the sellers in case the transaction fails to close due to certain events or circumstances by the financial sponsor, which serve as compensation for the sellers' opportunity cost and due diligence expenses.
- The deposit of the consideration in an escrow account for the closing process and transfer of shares.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

Locked box pricing mechanisms are commonly used in M&A transactions in Egypt and have become prevalent in the market. It is the dominant form of consideration structure employed in a wide range of transactions. Locked box mechanisms are often seen in transactions involving financial sponsor sellers. This type of seller typically prefers this pricing mechanism because it can provide a fixed purchase price based on a predetermined financial snapshot of the target company. This approach allows financial sponsors to align their interests and investment objectives with the historical financial performance of the target.

Currently, the inflation and its effects on the target performance and valuation, we believe that the financial sponsors as buyer may refrain from the locked box mechanisms, as they will aim for a mechanism that allows for a better price adjustment in case of non-performing target before closing.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

The typical methods and constructs of how risk is allocated between the parties of a transaction begin with legal due diligence to identify the areas of risk and to determine the appropriate price, structure, and terms of the transaction.

Based on the outcome of the legal due diligence, the parties can address the risk allocation in the sale and purchase agreements using several mechanisms, including conditions precedents, representations and warranties, indemnities, and escrow arrangements. The choice and extent of these methods and constructs depend on various factors, such as the type, size, and structure of the transaction, the regulatory environment, the due diligence findings, and the parties' negotiations.

In general, the seller will provide warranties for the period prior to the closing. Usually, the business warranties will have a survival period of 2 years as of closing and tax warranties 5 years as of closing. The seller will be protected by the disclosure letter (exclusion schedule) to limit the exposure of such surviving liability post-closing and will also aim to set a cap on the liability with an amount that usually ranges from 20%-30% from the consideration. The buyer will be protected by the representations and warranties provided by the seller, and also retaining a portion of the consideration as collateral for future claims, if any.

7. How prevalent is the use of W&I insurance in your transactions?

While W&I insurance is a common tool in M&A transactions in some jurisdictions, it is not in Egypt. In transactions, parties rely on the contractual provisions of the sale and purchase agreements and the law to protect the parties' interests and mitigate or allocate the risks. In addition, normally will open an escrow account and retain arrange from 10% to 20% of the consideration as a collateral for any breach in relation to W&I.

8. How active have financial sponsors been in acquiring publicly listed companies?

Financial sponsors have not been very active in acquiring publicly listed companies in Egypt, mainly due to the mandatory tender offer rules that apply in such cases. According to the CML, any person who acquires, whether directly or indirectly, more than one-third of the voting rights or shares of a listed company, either alone or in concert with others, considered related parties under the CML definition, must launch a mandatory tender offer for 100% of the target company's shares. This requirement imposes significant costs and challenges for financial sponsors, who typically seek to acquire a controlling stake in a publicly listed company but not necessarily the entire share capital. Therefore, this form of transaction is not very common in Egypt. On the other end, financial sponsors often exit their investments in Egypt by publicly listing their portfolio companies on the EGX, providing an attractive exit option that allows them to realize their returns.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

Financial sponsors in Egypt's M&A transactions usually do not need foreign investment controls or other governmental consents, except to target companies that operate in real estate or have operations in Sinai. As a general rule for regulated entities, mainly operating in the field of financial non-banking sector, will require special approvals to validate the UBOs of the acquirer, regardless the acquirer being local or foreign investor.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

The Egyptian Competition Law no.3 of 2005 (ECL) was significantly amended by the Law no.175 of 2022 in December 2022, requiring parties to a transaction to obtain the Egyptian Competition Authority's (ECA) prior approval before effectuating this transaction if certain criteria are met. The ECA issued a statement on January 4th, 2023, that the merger control regime will not enter into force until the executive regulations of the ECL are issued, which will provide guidance and regulation on the application, interpretation, and exemption of the merger control. The ECL applies equally to any transaction in Egypt, regardless of whether the buyer is a financial sponsor or not.

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor

divests one or more portfolio companies to funds managed by the same sponsor?

There is an increase in minority investments in the venture capital and startups space, especially in the fintech industry. This is usually structured through convertible notes other than equity investment with minority protection. Yet, such investments will usually convert into equity upon redomiciling the target company in other jurisdictions that offer preferred shares and allow issuing different classes of shares (mainly common law jurisdictions), while the business operations continue to be in Egypt. As for the continuation fund, we note that after the collapse of Silicon Valley Bank, the financial sponsors have either divested from or refrained to deploying follow up funds in non-performing businesses, in order to keep its focus in other better performing businesses. As number of startups in Egypt have been heavily impacted by the Silicon Valley Bank crisis.

12. How are management incentive schemes typically structured?

The most common management incentive schemes are the Employee Stock Option Plan (ESOP) and the sweat equity shares. On the one hand, the ESOPs grant the management the right to purchase company shares at a predetermined price in the future. ESOPs are usually subject to vesting conditions, meaning that the management can only exercise their options after a certain period or upon meeting certain milestones. On the other hand, the sweat equity shares are shares issued by the company to the senior management for non-cash consideration, against providing know-how or value additions and management of the company, with a default call option in the event the management did not achieve the targeted results.

In terms of legal structure, the Egyptian Law has provided a regulation to the ESOP. Such regulation is usually adopted by listed companies whereby the company will allocate up to 10% of its capital for the ESOP. Such shares will be offered on the basis of the right to acquire the shares at a discount or financed by the company. Given, the complexity of the legal process under the regulation, non-listed companies will opt to implement the ESOP in the form of phantom shares (shadow shares), which is based on a contractual arrangement with the employee defining the economic rights related to the company equity. In the case of the latter, the employee will not be registered as a shareholder and will not have any voting rights.

We note that most startups will aim to acquire talents through ESOP, such start ups mostly will be structured in jurisdictions that allow the issuance of classes of shares.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

The tax rules concerning the grant of shares under management's incentive schemes depend on the structure of the scheme, as well as the financing of the scheme. In all events, the sale of shares granted under the management incentive schemes is subject to the same tax ruling. In other words, no special rates or tax are applied.

14. Are senior managers subject to non-competes and if so what is the general duration?

By law, senior managers in Egypt are subject to non-compete obligations during their term of employment. Such non-compete obligations may survive their employment contracts term, depending on their level of seniority. The general duration for the surviving period of the non-compete usually varies between 6 months to 2 years, depending on the industry and the manager's seniority.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

A financial sponsor typically exercises control over the material business decisions of its portfolio company by either acquiring a majority stake in the company and appointing a proportionate number of directors to the portfolio company's board of directors or securing certain governance rights under a shareholders' agreement. The rights under the shareholders' agreement may include appointing several directors to the board, and the ability to veto or approve key matters affecting the company's operations and strategy under a reserved matters clause.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

Management pooling vehicles are not currently common in Egypt. However, it used to be very common in major institutions that such vehicles are regulated by the CML and named employees union funds. Such funds were formed and adopted in major companies with a considerable number of blue coolers employees. The fund was able to acquire up to 5% of the company capital. The fund governance was subject to the FRA. Given the complexity of the legal regulations and governance, such funds have become less common in the past decade.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Capital financing in Egypt is mainly financed through equity financing, with limited debt finance involvement. We shall also note that the Central Bank of Egypt (CBE) have provided limitation on the debt financing for capital financing or acquisition capped at 25% of the company capital and in total 50% in case of syndicated loans. Yet recently, there has been an increase in debt financing through mezzanine financing, debt convertible instruments specially in the small and medium financings. For large capital financing companies may seek financing from foreign institutional banks or through bonds issuance specially companies providing non-banking financial services, which have benefited from the securitization regulation that came into force in 2022.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

Under the Companies Law, a company is not entitled to provide financial assistance to its shareholders. However, the shareholder is entitled to provide a financial assistance to the company in the form of a shareholder loan to assist the company in financing any capital commitments in any of the company’s subsidiaries.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

For typical financing, lenders usually rely on standard forms of credit agreements that have been previously developed, which, generally, are accepted as market practice. However, while there is limited room for negotiation between the lenders and the borrowers, depending on the specific circumstances and needs of each transaction, the level of negotiation may vary depending on factors, including but not limited to the size, complexity, and risk profile of the loan.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

The key areas of negotiation mainly related to the guarantees provided by the borrower to the lender, where the borrower will aim to minimize the personal guarantee while the borrower will aim to obtain extensive guarantee and collateral. Also, we note that borrower recently focus on limiting the acceleration events.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

There is no regulation in the Egyptian market related to the set of private equity credit funds. Yet, considering the limited available debt financing options, business in Egypt seeks financing from foreign based private equity credit funds. Also, there is an increase in the demand on the debt venture capital, and it is expected that such activity to be more regulated in Egypt soon.

Contributors

Omar Farid
Partner, Capital Markets and M&A

ofarid@alfegypt.com

Hagar Mohamed
Senior Associate, M&A

hmohamed@alfegypt.com

Ahmed Rady
Associate, M&A

arady@alfegypt.com