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United Arab Emirates Private Equity

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

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United Arab Emirates: Private Equity

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

Overall M&A activity in the UAE during 2021 was strong, in the context of the rebound from COVID-19. Deal activity in the UAE has remained strong during 2022 despite global uncertainty, buoyed by high oil prices and wide ranging legal reforms, including a relaxation of foreign ownership restrictions.

The private equity market in the UAE is still developing and there is not a large volume of precedent. Over the last 24 months, conventional private equity transactions have continued to comprise a small proportion of M&A deals in the UAE (according to Mergermarket data, M&A deals completed in the UAE during the period November 2020 to November 2022 that featured a venture capital or private equity buyer or seller accounted for around 5% of the total deals completed in the UAE during such period). Domestic and inbound M&A activity is driven by sovereign wealth funds, family offices, government-related entities and institutional investors.

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?

Participants in UAE M&A transactions are commonly trade sellers.

Upon an exit, the aim of a financial sponsor seller would typically be to achieve a "clean break" to enable a distribution of sale proceeds to the fund as soon as possible. Accordingly, a financial sponsor would generally seek to implement a locked box purchase price mechanism in order to achieve price certainty rather than a completion accounts mechanism, which would involve a potential purchase price adjustment and may result in a hold back of proceeds. Please see the comments at paragraph 5 on the use of locked box purchase price mechanisms in the UAE. Furthermore, a financial sponsor typically seeks to limit the warranties contained in the sale and purchase agreement to fundamental title and capacity warranties only. However, it is becoming more common these days on a financial sponsor sale for W&I insurance to be used in order to provide recourse to the

buyer for any breach of business warranties. In our opinion W&I insurance is now used in the majority of financial sponsor sales processes.

On the other hand, trade sellers in the UAE lack experience of, and therefore tend to be less comfortable using, locked box purchase price mechanics on an exit. Furthermore, trade sellers in the UAE are more likely to be willing to bear risk in relation to the target and to stand behind business warranties (subject to standard disclosure qualifications and limitations on liability).

As a general rule, financial sponsors are also more focused on limiting conditions precedent to completion as far as possible whereas trade sellers may be more amenable to including more fulsome CPs (e.g. a material adverse change CP).

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

A transaction involving a UAE company will (where relevant) typically require competent authority approval in respect of the application in relation to a transfer of shares. Limited liability companies, which are the most common form of company through which business activities are performed "onshore" in the UAE, are licensed and regulated by the local economic department of the Emirate in which they are established. Local economic departments are responsible for maintaining the Commercial Register, and their procedural requirements must be satisfied in order for a person to be registered as a legal shareholder (noting that their requirements can change so it is important to get up to date information as to current processes). Similarly, free zone companies are regulated by the relevant authority of the free zone in which they are established.

Furthermore, in order to effect an "onshore" share transfer (and certain free zone share transfers also), shareholders are required to attend a notary public in order to sign and have the relevant documentation and an updated memorandum of association notarised before they are submitted to the competent authority. Effecting a share transfer of a UAE "onshore" company, therefore, generally requires the cooperation of all shareholders.

In certain Emirates (e.g. Abu Dhabi), advertisement of summary details of any proposed share transfer is a mandatory step in the share transfer process. However, such advertisement is usually in the public Gazette which is not widely read or reported on.

There is currently no general transfer tax applicable to transfers of shares in the UAE. Competent authority registration fees will apply and, in respect of transfer of shares in "onshore" companies, notarial fees will also apply, however such fees are not material. Notary public fees in Dubai are specified by the Dubai Court to be 0.5% of the value of the shares being transferred, subject to a cap of AED15,000. It is market practice to assess value on the basis of the nominal value of the shares being transferred. Whilst a sponsor would typically acquire shares in a holding vehicle incorporated in the Dubai International Financial Centre or Abu Dhabi Global Market, it may be necessary to transfer an "onshore" operating company under such vehicle.

Moreover, where a company owns an interest in land onshore in Dubai (whether directly or indirectly through subsidiaries), and the shares in this company are transferred to a third party, the Dubai Land Department views this transfer as a transfer of a real estate interest upon which registration fees of 4% of the value for freehold or usufruct (long leasehold) properties will be assessed. There is also a risk that other Emirates will apply this procedure.

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

Financial sponsors would typically acquire shares in a target company through a special purpose vehicle. Certainty of funding would usually be evidenced to sellers by way of provision at signing by the financial sponsor of an equity commitment letter (representing a commitment to provide subscription monies for shares in the special purpose vehicle) in respect of the equity funded component of the purchase price. The equity commitment letter may also provide comfort around debt facilities available and their draw-down although leveraged deals are less common in this region.

A conditional debt commitment letter (attaching a term sheet or draft facility agreement) from lenders may also be delivered in respect of the debt funded component of the purchase price – although this is less common in practice.

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

On a buy-side transaction, private equity sponsors would typically seek a closing accounts purchase price adjustment mechanism. However, UAE private equity buy-side transactions are often in the context of competitive auction sales involving a locked box mechanism.

On an exit, typically a locked box purchase price mechanism would be sought in order to achieve price certainty and facilitate a prompt return of proceeds to the fund, rather than having to wait for a potential adjustment. However, to date, there are only a limited number of private equity exit precedents in the UAE and therefore market practice is still evolving.

Counterparties in UAE transactions are often regional trade sellers or buyers (private equity secondary market sales in the UAE are not common). Such counterparties may lack experience of using locked box purchase price mechanics. For this reason and others (such as lower quality of earnings/accounting when compared to other jurisdictions) locked box mechanisms are not as prevalent in the UAE when compared to other jurisdictions.

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

On balance, UAE transactions involving international private equity investors tend to be on more buyer friendly terms. Having said that, risk allocation is always a matter of particular negotiation and is deal-specific, in particular in the context of a competitive bid process.

On a locked-box transaction, a buyer assumes economic risk from the locked-box date (subject to leakage protection). Private equity buyers seek to manage risk through conducting due diligence and negotiating warranty protection from the seller. It is customary for the contents of the data room to qualify the warranties, to the extent matters are fairly disclosed. Tax covenants, pursuant to which a seller agrees to be responsible for all pre-completion tax liabilities of the target group, are increasingly common in UAE deals.

Although there are limited private equity exit precedents in the UAE M&A market, we would expect private equity sellers' starting position to be to refuse the giving of warranties to a buyer beyond customary title to the sale

shares and capacity to enter into definitive transaction documentation. However, in practice, sponsors sometimes need to provide some level of warranty coverage on an exit in the UAE, but in this situation we would expect the limitations and recourse provisions to be very prescriptive and heavily negotiated. Warranty and Indemnity insurance is commonly used to bridge any gap between these limited warranties and those required by the buyer.

Earn-outs are relatively common in the UAE, particularly in relation to founder-owned businesses which helps balance the risk for an incoming investor.

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

Historically there was limited use of warranty and indemnity insurance in UAE transactions, although it is now more prevalent. It is now fairly common in transactions involving an international private equity sponsor or other sophisticated buyer. For a private equity seller in the UAE, the use of warranty and indemnity insurance is the preferred option to bridge the gap between a sponsor's unwillingness to give, and a buyer's insistence to receive, business warranty protection.

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

There is no precedent of a financial sponsor acquiring a publicly listed company in the UAE. Public M&A activity in the UAE has historically been limited, in part due to the ownership structure of UAE listed companies which often involves significant stakes being held by UAE governments. Only in 2017 did the UAE introduce rules specifically governing takeovers, which is applicable to companies listed in the onshore exchanges of the Abu Dhabi Securities Market and the Dubai Financial Market.

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?

A common cross-border consideration in the UAE is foreign ownership restrictions. Federal Law No. (32) of 2021 on Commercial Companies introduced a relaxation of foreign ownership restrictions in the UAE onshore environment effective from March 2021. Emirate-level economic departments therefore have discretion to

determine the sectors and business activities where up to 100% foreign ownership is permitted (subject to a strategic impact list where foreign ownership is still restricted as referred to in the UAE Commercial Companies Law). Where a UAE local partner is required, a sponsor should consider putting in place certain customary 'nominee' arrangements that effectively vest legal and economic control over the business with the sponsor.

Furthermore, any foreign company acquiring shares in a company that owns real estate interests (whether directly or indirectly through subsidiaries) should be aware that all of the Emirates have rules around foreign ownership of real estate interests (subject to certain 'designated areas' where foreign ownership is permitted) and that any foreign ownership, anywhere in the corporate chain (including any foreign entities in the ownership chain), may result in the company being deemed foreign for the purposes of such rules.

As stated at paragraph 3, a transaction involving a UAE business will (where relevant) typically require competent authority approval in respect of an application in relation to the transfer or issuance of shares.

Note further that with the introduction of UBO registers in the UAE, all regulatory authorities are now requiring clear and detailed information in relation to a corporate group's ultimate shareholding which may involve requesting passport copies of controlling individuals (at both shareholder and board level).

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

The UAE's competition law regime, which is suspensory, came into effect in 2013 and implementing regulations came into effect in 2014 and 2016. The UAE merger control regulator, the Competition and Consumer Protection Department of the Ministry of Economy, has been established and has issued a template merger filing form. To date, several merger control filings have been submitted. However, the competition law regime in the UAE is nascent, with little published guidance and no case law.

The UAE competition law regime requires that a merger control filing be made in respect of an economic concentration where (i) the market share of the parties to the transaction will exceed 40% of the total transactions in the relevant market AND (ii) the concentration would have an effect on competition in the market. Whilst the

precise meaning of the second limb remains to be settled, market practice is to interpret this as requiring an overlap of the activities of the transaction parties in the relevant market. Accordingly, financial sponsors tend to take the view that where there is no overlap of activities, there is no obligation to file.

Penalties for failing to comply with UAE law merger filings may be a fine of between 2-5% of annual turnover of relevant products or services in the UAE or a fine of between AED500,000 to 5,000,000. In light of such potential penalties, specific legal advice relating to merger control considerations should be obtained on a transaction-by-transaction basis.

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?

As noted in paragraph 1, there is limited private equity precedent in the UAE. However, we have recently seen more "structured equity" type investments in the UAE, where sponsors participate in the capital stack by way of preferred equity or equity-linked debt type instruments which rank ahead of ordinary shares but are subordinate to senior debt. Such participation typically involves the right to a minimum fixed rate of preferred return and the potential for additional equity upside. For a sponsor, this provides more certainty around achieving an exit (through a redemption or repayment mechanism) and for other shareholders, enables retention of control.

Minority investments are more common in the venture capital space, in relation to which a range of capital structures feature, including preferred equity and debt instruments, the latter held by mezzanine debt funds who may require an equity kicker to reach the desired IRR.

12. How are management incentive schemes typically structured?

Management incentive schemes involving the issuance of 'hard' equity to members of the management team are less common in the UAE than in many other jurisdictions. The main driver behind this is that, given the current tax landscape in the UAE with no income or capital gains tax

payable by individuals, there is no tax advantage for management in holding shares. Consequently, considerations around equity appreciation being taxed at capital gains tax rates (rather than employment income tax rates) is not applicable in the UAE. Please note that no change to the tax regime applying to individuals is currently envisaged and so we do not expect the general approach to 'hard' equity changing in the near future.

In addition, in circumstances where an investment structure does not include a DIFC or ADGM 'holdco', there are practical considerations that render the establishment of 'hard' equity management incentive schemes challenging:

- Share classes – "onshore" companies cannot issue different classes of shares with bespoke rights attached to each class. As a result, it is very difficult to have a 'management' class of shares.
- Share transfers and other corporate actions – in order to effect an "onshore" share transfer or undertake certain other corporate actions (e.g. amending the constitutional documents), all shareholders are required to attend a notary public in order to sign and have the relevant documentation and an updated memorandum of association notarised before they are submitted to the relevant authorities. The reliance on all shareholders being present or agreeing to the relevant action increases the risk that an exiting manager may frustrate certain actions, including the transfer to the company or another shareholder of any shares issued as part of a management incentive plan. It also means that the enforceability of 'drag-along' and 'tag-along' provisions (both legally and practically) is extremely questionable.

The combination of the tax considerations and practical difficulties set out above mean that contractual 'phantom' equity, option or profit-sharing schemes are more common in the UAE, particularly outside of the financial free zones.

Note that due to inheritance issues and Islamic *Shari'a* jurisprudence, it is recommended that shares are held through corporate vehicles rather than directly by individual shareholders.

13. Are there any specific tax rules which commonly feature in the structuring of

management's incentive schemes?

See paragraph 12 for commentary on tax considerations relating to management incentive schemes in the UAE.

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

Typically, senior managers are subject to non-compete restrictions in their employment contracts of around six to nine months, sometimes 12 months. In the UAE (outside of the DIFC), the duration of a non-compete clause is limited by law to two years, however historically, courts have been generally reluctant to enforce non-compete restrictions that are longer than six to 12 months depending on the level of seniority of the relevant individual and the amount of confidential and sensitive information that person is in possession of.

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?

In the UAE, governance provisions are typical of those in other jurisdictions and usually include:

- Board representation – investors will nearly always have a right to appoint a number of investor directors with at least one investor director required to be present for a quorum to exist at any board meeting.
- Reserved matters – investors (and other significant shareholders) will nearly always have a list of reserved matters requiring their consent.
- Business plan and annual budget – in most investments, the management team is typically expected to prepare an annual business plan and budget for the portfolio company for approval by the board with the consent of the investor. Management teams are often required to report to the investor on progress as against the business plan and budget on a quarterly or half-yearly basis.
- Delegation of authority / authority matrix – it is common in the region for there to be a delegation of authority or authority matrix established at the outset of an investment setting out the matters that the management team can carry out without the consent of the

investor or the board.

- Reporting requirements – customary reporting requirements are usually included in the transaction documents to ensure that the management team provides the investor with copies of relevant financial information, such as management accounts, quarterly reports and audited accounts, within a specified time period. In line with global trends, there has also been a rise in interest and requirements for non-financial ESG reporting to private equity investors.

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

For the reasons stated at paragraph 12, the issuance of 'hard' equity to employees less common in the UAE than in many other jurisdictions. Accordingly, the use of management pooling vehicles is uncommon in the UAE.

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

Leveraged acquisitions can be financed in a number of ways, including through a combination of senior and mezzanine facilities, and the debt capital markets. In the UAE the most commonly used structure remains through senior banking facilities, whether on a syndicated or bilateral basis depending on the size of the financing. Whilst we have seen mezzanine facilities coming in subordinated to the senior lenders, that is not the norm, and it is still relatively unusual to see debt financings with a second lien tranche sharing on the same security as the senior lenders. Even for banks and financial institutions it may be difficult to get acquisition financings through their credit committees. One reason for this, is that acquisition financings are seen by banks as complex transactions requiring oversight by the banks' investment banking teams. At the same time, investment banking teams usually require minimum financings of about \$100 million in order to get involved. As a result, we generally see banks financing high-value acquisitions, such as the acquisition of Americana. In the region, however, the majority of private equity led acquisitions are relatively small, leaving a substantial amount of buyouts financed exclusively with equity. We sometimes do see a workaround implemented by banks in the region, in particular where the target is an existing client of the bank – banks may sometimes provide financing at the target level the proceeds of which may be used to pay the

seller of the target. This vacuum in the market for bank financed small and mid-sized acquisitions has also created an opportunity for credit funds to fill in the gap.

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

Article 224 of the Commercial Companies Law No. 32 of 2021 (CCL 2021) states that neither a public joint stock company nor its subsidiaries may provide financial aid to any shareholder to enable him to own shares, bonds or Sukuk issued by the company. Financial assistance is widely defined under Article 224 and includes providing (i) loans; (ii) gifts or donations; (iii) providing security over the assets of the company; and (iv) providing security or guarantee in respect of third party obligations and (v) using any of the company's reserves, funds or profits generated to pay that person's obligations. Article 224 excludes from the prohibition (i) any guarantees, undertakings or compensation provided to any underwriter during an offering or subscription of the company's shares; and (ii) any loans provided by any company licensed by the UAE Central Bank to any person to enable that person to hold any securities issued by such company provided that the loans granted do not include any preferential terms that they do not grant to their other clients and in a manner that does not conflict with the legislation and regulations in force at the Central Bank.

Under the old Commercial Companies Law No 2 of 2021, it was unclear initially whether the financial assistance prohibition would apply in respect of limited liability companies. Ministerial Resolution No. 272 of 2016 then clarified that the financial assistance prohibition under the Commercial Companies Law No 2 of 2015 does not apply to UAE Limited Liability Companies. We understand that unless new regulations are issued, the terms of Ministerial Resolution No.272 of 2016 will continue to apply to equivalent provisions of the CCL 2021.

JSCs on the other hand remain subject to the financial assistance prohibition, without the possibility of following "whitewash" procedures.

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?

The Loan Market Association precedent for leveraged

acquisitions remains the standard form of credit agreement preferred by both banks and financial institutions and credit funds alike. However, there may be variations to it if the financing is Shari'a compliant. Equally, where notes or sukuk (usually privately placed) are used, then there is no real industry standard as such.

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

Equity cures are quite heavily negotiated. An equity cure gives the sponsor the ability to "cure" a financial covenant breach by injecting additional funds into the borrower. Clearly borrowers and sponsors like to have the flexibility to cure financial covenants breaches as often as necessary. Lenders will want to ensure that equity cures are not used excessively and in particular are not used in consecutive test periods. We note that one of the main reasons for having financial covenants is to give lenders the ability to accelerate the facility long before the borrower becomes unable to service debt. Allowing sponsors to cure financial covenants in consecutive periods essentially takes away from that lender discretion to accelerate if there are clear signs that the borrower is in financial trouble. Lenders must also consider that there can be quite a lag until financial covenants can be tested by reference to the audited financials – it is not uncommon in the UAE that borrowers get 180 days after the end of a financial year to produce audited financial statements. If you add consecutive equity cures, the problem compounds and lenders may find that their right to accelerate the facility is only triggered once the company is in deep financial troubles. There is usually an overall limit to the amount of cures which can be exercised during the tenor of the facility. Another contentious point on the equity cure is on what basis are financial covenants recalculated once the funds are injected into the borrower (usually by way of subordinated new shareholder loans). Borrowers have typically argued that the new cash injection should be added to the EBITDA side of the leverage ratio. Lenders, on the other hand, will want the new shareholder injections to be applied to reduce debt.

Another point of contention between lenders and borrowers is the transfer provisions. Borrowers in the region like to rely on personal relationships developed with their lenders. Their view is that their relationship bankers or private lending connections will always make an effort to extend maturities in the event that the borrower runs into financial difficulties which is why they want to know that the lender will not sell down the debt.

Similarly, reaching an agreement on a restructuring with distress debt funds purchasing debt in the secondary markets will typically be more difficult than with local banks and financial institutions. On the other hand lenders tend to assure borrowers that they do not intend to sell down or transfer their participations in the loan, whilst at the same time insisting on an unrestricted ability to do so. Borrower are often also concerned about confidentiality and competitors purchasing debt in the secondary markets in order to benefit from the information covenants in favour of the syndicate banks. It is therefore not uncommon to see restrictions on transfers of participations to competitors of the borrower.

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

See question 17 – the shortage in available banking finance for small to medium size deals has created opportunities for private credit funds. Many of the active credit funds in the region target transactions between USD 15 million to USD 50 million. Depending on the size and risk involved in the financing, it is not unusual to see two or three credit funds club together for a deal. They will also have their own individual requirements in terms of pricing, payment in kind and equity kickers as well as whether the financing needs to be Sharia' compliant or conventional or made through a liquid instrument such as cleared notes.

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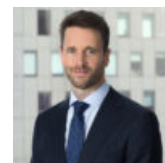
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