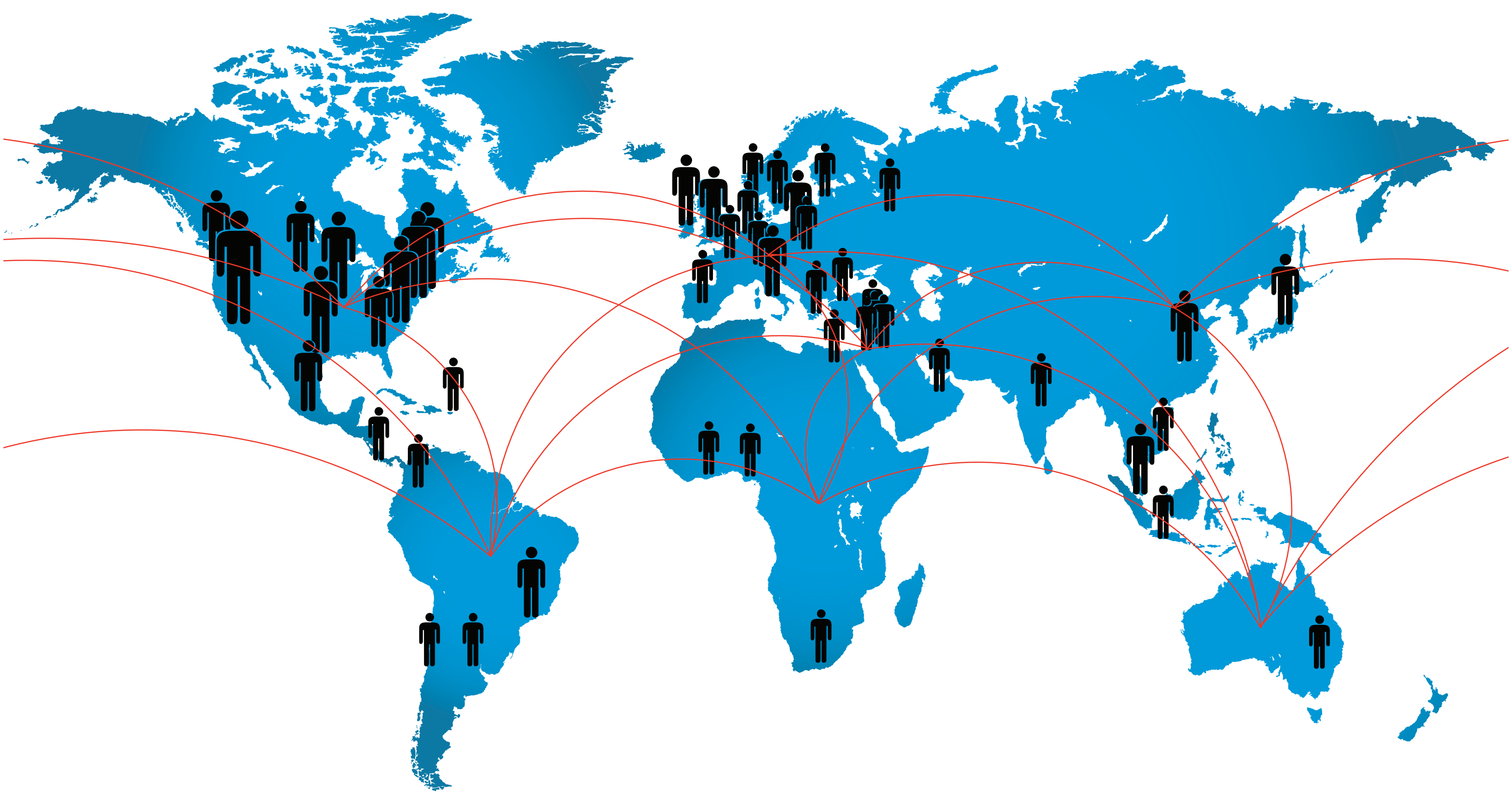
Kauffman Fellows REPORT 2015 vol. 6

Forward-thinking articles from our global network of innovation ecosystem experts



Kauffman Fellows

KFR Staff

Publisher
Kauffman Fellows Press

Executive Editor
Phil Wickham

Managing Editor
Anna F.Doherty

Associate Editor
Leslie F. Peters

Production and Design
Anna F. Doherty
Leslie F. Peters

Printer
Almaden Press
www.almadenpress.com

About the Editor
Anna F. Doherty is an accomplished editor and writing coach with a unique collaborative focus in her work. She has 20 years of editing experience on three continents in a variety of business industries. Through her firm, Together Editing & Design, she has offered a full suite of writing, design, and publishing services to Kauffman Fellows since 2009. Leslie F. Peters is the Lead Designer on the TE&D team. www.togetherediting.com

SOCIETY ACADEMY
CAPITAL PRESS

www.kauffmanfellows.org
Town & Country Village • 855 El Camino Real, Suite 12 • Palo Alto, CA 94301
Phone: 650-561-7450 • Fax: 650-561-7451

A Hybrid Venture Capital Model for the Middle East

Tarek Sadi

Class 17

Youth unemployment in MENA, according to the Skoll Foundation, is around 26% and among certain demographics it goes up to 65%.[1] Governments and large corporations are doing everything they can to create jobs, but more is needed. It is crucial that an efficient and successful venture capital industry be created to fuel further economic growth, and therefore employment. The first venture capital funds were launched in the Middle East and North Africa (MENA) in 2010, a promising beginning. At Endeavor, a global nongovernmental organization committed to transforming world economies by supporting the world's most impactful entrepreneurs, we believe more can be done to build a successful venture capital industry in the MENA region.

To understand the challenges for venture capital and the best way to unlock its value in the region, I conducted a series of interviews with three distinct groups of stakeholders to understand their perspectives:

1. Ten active family offices in the Middle East.
2. Five entrepreneurs who have raised capital in the region and beyond.
3. Four venture capitalists who have been actively looking for opportunities in the region.

Having had the good fortune of being an entrepreneur and an investor across three continents before joining Endeavor, I have no doubt of the power that entrepreneurs and investors have when their interests are aligned. In this article, I use the interview data to explore how to accelerate the creation of new venture capital funds in the Middle East, so that entrepreneurship can achieve accelerated job creation and economic growth.

The Situation on the Ground

Interviewees revealed three main challenges to venture capital in the Middle East and North Africa.

Lack of LPs

None of the potential LPs whom I interviewed view venture capital as a viable asset class in the region (even though four of the five are limited partners in U.S. funds, and understand the asset class). Venture returns are unproven in MENA, while returns from more

[1] Jamie McAuliffe, "Addressing the Youth Unemployment Crisis in the Middle East," *Skoll World Forum*, 9 April 2013, http://skollworldforum.org/2013/04/09/addressing-the-youth-unemployment-crisis-in-the-middle-east/.

traditionally non-liquid assets in the region, such as real estate, are high—yielding in some cases 3x in two years.[2] This investment environment increases the opportunity cost for investors, making local VC funds a less attractive asset.

All three family offices I interviewed also raised the concern that there are few credible VC investors in the region. According to the CEO of one of the largest family-run industrial groups in Saudi Arabia,

> We see great fund managers when we invest as LPs in the U.S. and Europe, but in the region I have not come across fund managers that we could back.…VC is not in the culture that we have in the Middle East. Bring me someone who worked for 10 years at Sequoia and I will back him.[3]

Lack of Venture Capital Diversity

As of this writing, there are 15 venture capital funds active in MENA. By country, these funds are distributed as follows: Lebanon (3), Jordan (4), Saudi Arabia (3), UAE (3), and Egypt (2). Only three of these funds invest significantly on a regional level (Wamda, MBC Ventures, and STC Ventures). The relatively small number of funds operating in each country allows for active cooperation among the funds, to the detriment of entrepreneurs.

Entrepreneurs can face a barrier when raising capital, as term sheets are often standardized across the funds and therefore very tough. According to Ghaith El Yafi of ScoopCity, a daily deal website and online retailer targeting a high-end demographic, the term sheet they got while raising their Series A round was punitive. When they tried to negotiate, it was made very clear that there was no room to maneuver: Either they accepted the provision to guarantee the returns to the VCs through a put option, or they would not get the investment. The second fund they went to did exactly the same.[4]

[2] Interview with CEO of leading family-run business in Saudi Arabia, 22 April 2014.

[3] Interview with CEO of leading family office in the Middle East, 22 April 2014.

[4] Ghaith El Yafi (founder of ScoopCity), interview, 15 May 2014.

Once the investment is made, entrepreneurs usually find little value-add from their VCs. According to Rabih Nassar of Element N, "I saw my investors on the day we signed, and since then I get a call every few months asking me how things are going; beyond that, there is no interaction."[5] This was a recurrent theme across the five interviews I conducted with entrepreneurs. This VC situation de-motivates entrepreneurs and can act as a deterrent to launching new businesses.

Limited Pipeline

Although there is increasing momentum in entrepreneurship in the Middle East, quality startups and scale-ups in the market are few. Since 2007, there have only been three major success stories—the acquisition of Maktoob by Yahoo! in 2009 at an estimated $164 million,[6] the acquisition of Diwanee by Webedia for an estimated $30 million (including $5 million in capital increase),[7] and the acquisition of Talabat by Rocket Internet for $170 million.[8] International investors have also made two sizable Series C investments (Sooq.com, Marka VIP).

Five years after Yahoo acquired Maktoob, Webedia recognized that Diwanee was a well-run business with a clear vision and strategy, and that at the time, it was MENA's only digital-content business run at a global standard. The core of Diwanee's successful acquisition (i.e., the global standard) existed because of the rich experience of the company's founders and team. Theirs is a rare case in the region, as most entrepreneurs have only a few years of experience before launching their own businesses. In another of these five successes—Marka VIP—the

[5] Rabih Nassar (CEO of Element N), interview, 9 May 2014.

[6] CrunchBase, "Yahoo! / Maktoob," 26 February 2010, https://www.crunchbase.com/acquisition/0be25f0c9e835122ae9d68b3980fdf48.

[7] Nina Curley, "Majority Stake in Diwanee Acquired by Paris-based Digital Publishing Company Webedia," *Wamda*, 19 March 2014, para. 2, http://www.wamda.com/2014/03/diwanee-acquired-by-paris-based-digital-publishing-company-webedia.

[8] Lucy Knight, "Rocket Internet Acquires Kuwait's Talabat for $170M, Largest MENA Tech Acquisition since Maktoob," *Wamda*, 11 February 2015,para. 1, http://www.wamda.com/2015/02/rocket-internet-acquires-kuwaits-talabat-for-170m-largest-mena-tech-acquisition-since-maktoob.

founder had seven years experience at Zazil in the Bay Area before returning to the Middle East.

Local MENA funds I talked to argued that without a stronger pipeline, it is hard for them to give better terms and be more hands-on with their portfolio companies. According to Antoine Boustany of Saned Investments,

> We want to support our investments more actively, but investing in a large number of small early-stage opportunities makes it very difficult to do so from the start. As we start seeing outliers, we start honing our efforts on them.[9]

Interviewees revealed that governance in the funds I spoke to is often weak, and GPs do not have to demonstrate to their LPs how much effort they put in to supporting portfolio companies. With more engaged LPs, however, this relationship will change.

Leverage Points for Change

The interview data on barriers to successful venture capital growth in the region can be summarized as follows.

1. LPs do not see VC as a strong investment compared to other opportunities.
2. LPs would prefer to back more experienced VCs.
3. VCs do not find quality opportunities that they can easily exit, so they protect their capital by over-structuring.
4. Entrepreneurs are generally not experienced.
5. Entrepreneurs often get poor deals because there is not enough VC diversity to create a competitive funding marketplace for them.

To accelerate job creation and innovation in the region, venture capital firms need better access to both capital and opportunity. While most potential LPs are reluctant to invest in venture in the region, an added incentive to compensate for the lack of current returns could unlock this capital.

As most of these LPs are family offices tied to businesses that specialize in specific sectors, VCs should build funds that are relevant to these family businesses in order to add a strategic component that will compensate for the lower returns they are currently perceived to yield. In other words, GPs should position themselves as “outsourced” corporate VCs to these family offices, with transparent investment structures and incentives for the VCs and the entrepreneurs. Entrepreneurs will benefit because of the support they can get from these groups and from more specialized VC funds.

Of the 10 family offices that I spoke to, 7 mentioned that they already invest in and acquire opportunities relevant to their core businesses. On the other hand, all view startup investment opportunities as too small and too much work to make a difference to their core business. When asked whether they would back a fund that would help grow companies relevant to their core industries, however, four of these family offices said they would be interested.

It is important to note that some of these groups have acquired companies in Europe to gain their technologies, which they then use in their core businesses. Investing in young companies with specific intellectual property is therefore not a foreign concept to these corporations, and blending this strategy with a VC approach is worth exploring.

In the usual structure, LPs are mainly mutual funds, pension funds, and insurance companies—very different from the private equity funds and strategic buyers that venture funds seek to exit to. In the Middle East, however, there is a challenging conflict of interest. The same groups that are potential LPs are also the exit strategy for investments in the region. Successful venture capitalists must recognize and accept this reality, and address the potential conflicts of interest.

A Hybrid Corporate VC Model for the Middle East

At Endeavor, we believe successful entrepreneurial ecosystems are created around core competencies that are found locally, leveraging local expertise and demand. Most MENA startups to date have been clones of successful U.S. and European models that focus

[9] Antoine Boustany (Managing Director of Saned), interview in Beirut, Lebanon, 14 May 2014.

on consumers, with less attention given to local market dynamics. While companies such as Marka VIP and Souq.com (both in e-commerce) are making around $100 million and $400 million in revenue per year, respectively, no other digital businesses in MENA have yet reached that level of scale in terms of revenues or subscribers.

The VCs and entrepreneurs I interviewed stated that this lack of momentum is due to limited exit opportunities. As discussed above, exit routes are unclear in the region, making it difficult to find additional funding beyond Series A. According to Antoine Boustany of Saned Ventures, a pan-regional seed stage investor, a number of their portfolio companies are limited in their follow-on investment options, straining the resources of seed investors trying to finance their growth. This barrier to scale-up in turn limits the creation of new companies, and thus the momentum around entrepreneurship is less than desired.

A model that aligns startups with the needs of the region would also align innovation with the requirements of the large corporations in MENA who become the exit strategy for these entrepreneurs. This model will help fuel existing industries, increasing innovation in these sectors and help to create sustainable, long-term economic growth. Furthermore, as more companies from MENA expand into Africa and South Asia, this "outsourced" innovation will become an important source of competitive advantage in new markets.

Upon preliminary analysis, four sectors in MENA have built considerable expertise and compete both locally and globally. These sectors would most benefit from such a hybrid VC model: oil and gas, warehousing and logistics, food manufacturing, and construction.

By partnering with VCs who tailor their portfolio to local needs, MENA's leading corporations will benefit from new sources of innovation and agility, while strengthening the competitiveness of their business at a global level. As Palo Alto is a global tech hub, Dubai can become a global hub for innovation in logistics. As Boston is today a global hub for life sciences, Khobar in Saudi Arabia can become a hub for innovation in oil and gas. Instead of importing technology and innovation, these regions can export it. This shift has the potential to transform the MENA region and its economies.

Case Studies

Existing examples of local innovation helping regional businesses grow indicate a real need for innovation by acquisition. Two case studies of recent successes illustrate the potential of this hybrid VC model.

Aramex and InfoFort

InfoFort was launched in 1999 as a document and data storage startup in Dubai. By 2001, it had expanded into Egypt where it quickly became the leading data-management company. Aramex, the leading regional courier business, was developing a strong offering in terms of warehousing and logistics, and saw InfoFort as an opportunity to leverage its infrastructure further while developing a deeper relationship with its clients. Aramex acquired InfoFort in 2005 and rolled it out across MENA. Today, InfoFort is the leading data management company in the Middle East and Africa, and a core offering of Aramex.[10]

If InfoFort had had VC support from launch, however, it could have scaled up faster and yielded a better return for its investors. This difference would in turn have allowed Aramex to expand its footprint and new service more aggressively.

Abdul Latif Jameel (ALJ) and Marka VIP

ALJ, the leading car distributor in Saudi Arabia, invested an estimated $40 million in Marka VIP, a leading regional e-commerce business. This investment was strategically important for Marka VIP to leverage ALJ's know-how of the Saudi market. For ALJ, a company based on consumers in the Middle East, access to the knowledge developed at Marka VIP gives it a unique insight on how to evolve its relationship with its customers online as the region becomes more connected.[11]

This access would have been very difficult for ALJ to achieve on its own without acquiring a

[10] Endeavor Lebanon sources; Riad Ghandour (investor), interview, 5 May 2014.

[11] Endeavor Lebanon source; I am also a seed investor.

share in a business that had built this expertise over the previous years. By investing in Marka VIP and gaining insight into the e-commerce world, ALJ will be able to learn more about the sector, gain expertise around e-commerce execution, and potentially identify ways to benefit its core business. With its investment, ALJ acquired innovation while funding a leading regional scale-up.

Real-Life Potential

Both of these examples, albeit very different, show the importance of entrepreneurship to corporations in the region and highlight the symbiotic relationship that governs innovation in the Middle East. In the hybrid model proposed here, VCs focus on exploiting that dependency, which allows them to quickly demonstrate to investors the returns that innovation can yield in a region where the true power of entrepreneurship has traditionally been underestimated. This access to innovation on a local level will help to fuel the creation of new funds and drive investors to back them, as these same LPs will not only benefit financially from their investment but also in kind as entrepreneurs help their companies innovate. At Endeavor, we are adamant that the key to reducing unemployment in MENA is leveraging the financial reach of large regional businesses.

Next Steps for MENA Entrepreneurship

This preliminary idea will benefit from further analysis, such as an investigation into each of the named sectors to understand their potential and requirements. There are also clear conflicts of interest in this model that need to be addressed, primarily, how to encourage LPs to pay to build something they will most probably end up buying themselves. Nonetheless, the potential returns are inspiring, both for individual stakeholders and for the region as a whole.

As part of Endeavor, my goal is to encourage companies in the region to play the crucial role of funders and acquirers of innovation. Like Aramex and ALJ, by having access to the right entrepreneurs they can evolve their groups and compete on a global level. We intend to help grow MENA startups into successful companies, and to align with—instead of against—the business culture of the region, by offering professionally managed VC funds that cater to the region's LPs in their roles as both investors and acquirers.

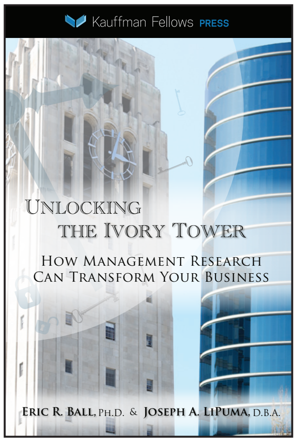
Existing VC funds in the region have helped created a fertile ecosystem where entrepreneurs view building world-class companies as a viable professional path. Today, a small number of growth funds are being created by those same GPs looking to finance their best portfolio companies through their next investment rounds. Funds such as Wamda, Beco, iMena, Sadara Ventures, and Leap are targeting bigger tickets across the region, which will encourage more traditional capital such as high-net-worth individuals and family offices to engage in VC. In my opinion, this growth will be a catalyst for exits in the region, creating further confidence in LPs who will continue fueling creativity and innovation in a region that is trying to diversify its resources and income. By waking these "sleeping giants" with the promise of global investment opportunities in their backyard, VCs will help the Middle East and North Africa to curb its unemployment time-bomb.

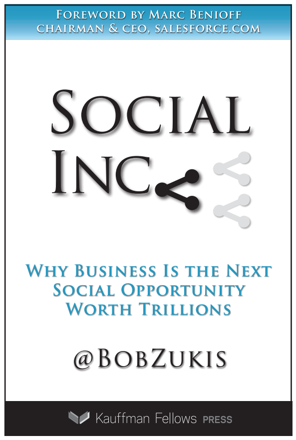
Tarek Sadi

Tarek is the Managing Director of Endeavor Lebanon, an economic development nonprofit focused on supporting outperforming entrepreneurs to create jobs and transform economies. He has extensive experience in venture capital and corporate finance in the Middle East, Europe, and Latin America. Tarek also launched and exited two startups in Mexico. He holds a BS in political science and economics from Georgetown University, and an MBA from London Business School. Kauffman Fellow Class 17. tsadi@endeavor.org

Table of Contents for *Kauffman Fellows Report* Volume 6

Consider submitting your book proposal to the Kauffman Fellows Press. Publishing services available to members of the Kauffman Fellows community on a broad range of topics relating to capital formation. Contact press@kfp.org.





The premiere leadership organization in innovation and capital formation globally, Kauffman Fellows operates at over 400 venture capital, corporate, government, and university investment organizations in 50+ countries. Commencing each summer, the latest class of 35 Kauffman Fellows engages in a practical 24-month apprenticeship that includes quarterly sessions in Palo Alto, California, field research projects, mentoring and coaching, and industry and regional events. During the fellowship, Kauffman Fellows work full-time at venture firms or related organizations committed to building innovative, high-growth companies.

Inspired by Ewing Marion Kauffman and his legacy of shared ownership, accountability, and experimentation, we measure success in enduring new businesses that generate long-term returns for principals, investors, and society as a whole.

The following firms have participated in the Kauffman Fellows Program since its inception.

.406 Ventures • 212 Ltd. • 3i • 3M New Ventures • 500 Startups • 5AM Ventures • Aberdare Ventures • Abraaj Capital • Accel Partners • Accelerator Corp. • Acumen Fund • Advanced Technology Ventures • Advent International • AES Corporation • Africa Angels Network • Agency for the Promotion of Innovation (Italy) • Alliance Technology Ventures • ALMI Invest • ALPHA Associates • Alsop-Louie Partners • Alta Partners • Amadeus Capital Partners • Amgen • Andes Capital • Andreessen Horowitz • Angel Ventures Mexico • Angeleno Group • Angels Forum • Apax Partners (Patricof & Co.) • Applied Ventures • Aquilo Capital Partners • ARCH Venture Partners • Archangel Informal Investment • Ascend Venture Group • Ascension Ventures • Asia United Capital • Astrec Invest • Atlantic Bridge • Atlas Venture • Austin Ventures • Austral Capital • BADIR Program • Baroda Ventures • Battelle Ventures • Battery Ventures • Bay City Capital • BBC Worldwide • BDC Canada • Biotechnology Value Fund • BioVentures Investors • Bloom Equity • Blue Chip Venture Company • Blueprint Ventures • Bridgescale Partners • Broad Institute • Brown Savano Direct Capital Partners • Burrill & Company • CalCEF Clean Energy Angel Fund • Canaan Partners • Capital Indigo • Carbon War Room • Cardinal Partners • Carlyle Group, Brazil • Centennial Ventures • Central Texas Angel Network • Chicago Ventures • CID Equity Partners • Cisco • CITIC Capital • Citrix Startup Accelerator • Clearstone Venture Partners • Clovis Oncology • CMEA Ventures • Cocoon Ventures • Comcast • Core Innovation Capital • Correlation Ventures • Creandum • Credo Ventures • Crescendo Ventures • Cromwell & Schmisseur • CSK Venture Capital • Databank Private Equity • DBL Investors • Dell • DFJ Network • Doll Capital Management • Domain Associates • dPixel • Draper Fisher Jurvetson • Draper Nexus Ventures • Easton Capital • Eastpoint Ventures • EC1 Capital • Echo VC • EDF Ventures • EMBL Ventures • Emergence Capital Partners • Endeavor Global • Endeavor Brazil • Endeavor Indonesia • Endeavor Jordan • Endeavor Lebanon • Endeavor Mexico • Endeavor South Africa • Endeavor Turkey • Essex Woodlands Health Ventures • European Investment Fund • Evolution Equity Partners • Expansive Ventures • Fidelity Biosciences • Finance Wales • Flagship Ventures • Flatiron Partners • Flywheel Ventures • Founders Fund • Fudan Univ. • Gabriel Venture Partners • Galicia Investments • GE Ventures • Gemini Israel Funds • General Atlantic • Genesis Partners • Gerbera Capital • Global Environment Fund • Golden Gate Ventures • Good Energies • Gotham Ventures • Granite Global Ventures • Gray Ghost Ventures • Greylock Partners • Groupon • Halo Fund • Hatteras Funds • Headwaters Capital Partners • Highland Capital Partners • Houston Angel Network • HSBC Private Equity (Asia) • Hyde Park Venture Partners • IDG Ventures India • IDG Ventures Vietnam • IE Business School/Vitamin K • IGNIA Partners • Imprint Capital • In-Q-Tel • INCJ • Indicator Capital • Innovationsbron • Institute for Venture Design • Intel Capital • Intersouth Partners • Invest4Good • Itochu • Johnson & Johnson • Joseph Advisory SVCS • JP Morgan Partners • Jungle Ventures • Kansas City Equity Partners • Karlin Asset Management • Kenda Capital • Kernel Capital • Keytone Ventures • Kickstart Seed Fund • Kitty Hawk Capital • Kleiner Perkins Caufield & Byers • Knight Foundation • Komli Media • L Capital Partners • Latin Idea Ventures • Lehman Brothers • Lepe Partners • Levensohn Venture Partners • Lilly Ventures • LSPvc • L Venture Group • Magazine Luiza • MAKOTO • MASA Life Science Ventures • Matter Ventures • Maxygen • McMaster Univ. • Mercury Fund • MEST Incubator • Mid-Atlantic Venture Funds • Ministry of Economy, Mexico • Mission Bay Capital • Mitsubishi • Morgenthaler Ventures • MPM Capital • NAFIN • National Semiconductor • NCB Ventures • NDRC • New Enterprise Associates • NIC Costa Rica • Nokia Siemens Networks • NOLA Project • Northwest Energy Angels • Northwest Technology Ventures • Northzone • Novartis Venture Fund • Nth Power • Nxtp.Labs • Oak Investment Partners • OKCupid Labs • Olympic Venture Partners • OMERS Ventures • Omidyar Network • OneLiberty/Flagship Ventures • ONSET • Opus Capital • Oracle • Oxford Capital Partners • Pacific Community Ventures • Panorama Capital • Pennyslvania Treasury Department • Physic Ventures • Playfair Capital • Prime Minister's Office, Singapore • Prism VentureWorks • ProQuest • Proteus Venture Partners • PTC Therapeutics • QBF/QIC • Quaker Partners • Qualcomm Technologies • Radius Ventures • RBC Venture Partners • Red Abbey Venture Partners • Research Corporation Technologies • Rice Univ. • Richard Chandler Corporation • Richmond Global • RiverVest Venture Partners • Riyada Enterprise Development • Robert Bosch Venture Capital • Roll Global • RRE Ventures • Rusnano • Sadara Ventures • Safeguard Scientifics • Sandbox Industries • SAP Ventures • Sawari Ventures • Scale Venture Partners • SEAF • Seaflower Ventures • Seedcamp • Sequel Venture Partners • Sequoia Capital India • Silas Capital • Sinbad Ventures • Skyline Ventures • Slated, Inc. • Sofinnova Partners • Sofinnova Ventures • SoundBoard Angel Fund • Sozo Ventures • Spectrum Equity Investors • Sprint • Sprout Group • SR One • Stanford Inst. for Innovation in Developing Economies • Startup Wise Guys • StartX • Storm Ventures • SV LATAM Fund • SV Life Sciences • Syngenta • T2 Venture Capital • TAQNIA • TauTona Group • Tech. Devel. Fund, Children's Hosp. Boston • Telecom Italia • Temasek Holdings • Texo Ventures • TL Ventures • Torrey Pines • TTGV • Tullis-Dickerson & Co. • TVM Capital • U.S. Food and Drug Administration • Ulu Ventures • Unilever Technology Ventures • Univ. of Tokyo Edge Capital • Universal Music Group • US Venture Partners • Valhalla Partners • VantagePoint Venture Partners • Velocity Venture Capital • Venrock Associates • VenSeed • Venture Investors • VentureHealth • Vickers Venture Partners • Viking Venture Management • Vilicus Ventures • VIMAC Ventures • W Capital Partners • Wellington Partners • Westly Group • Weston Presidio Capital • White Star Capital • Whitney & Co. • Wild Basin Investments • Wind Point Partners • Woodside Fund • Work-Bench • Zad Capital

Kauffman Fellows

SOCIETY

CAPITAL

ACADEMY

PRESS

printed locally on 100% post-consumer recycled paper