



Palestine Economic Policy Research Institute

Round Table Discussion (8)

**The Palestinian Private Investment Funds:
Challenges and Opportunities**

2012

Summary of Round Table 8 The Palestinian Private Investment Funds: Challenges and Opportunities

Date: October 1st, 2012

Introduction

The Round Table meeting, No. 8, entitled “The Palestinian Private Investment Funds: Challenges and Opportunities,” discussed the Palestinian private funds market; namely, whether private investment funds support the private sector in the OPT and provide local businesses and start-up companies with the necessary financing needs and business development opportunities? This background paper discusses the emerging trend of private funds, the pros and cons of these funds, their advantages on other traditional financial sources, and whether these funds can become a viable financing source in the OPT.

Speakers

Dr. Samir Abdullah: Meeting moderator

Mr. Bashir Assi: Visiting researcher at MAS

Mr. Fayez Hussein: Principal of Abraaj Capital, and Palestine Growth Capital Fund- PGCF

Ms. Abeer Hazboun: Executive director of the Palestinian IT Association of Companies- PITA

Questions for discussion

- ✧ What are the added values that private funds can provide to the Palestinian economy—in comparison to other traditional financing sources?
- ✧ What are the targeted sectors?
- ✧ What methods and practices have been chosen to facilitate adjusting to the needs of the Palestinian market?
- ✧ What are the culturally, legally, and organizationally appropriate policies and actions required to promote active and diligent private-funds management in the OPT?

Summary of speakers presentations

Dr. Samir Abdullah

Dr. Abdullah chaired the roundtable. He started by thanking the Friedrich Ebert Foundation of Germany, which supported the Round Table discussion program at MAS.

As a general introduction, Dr. Abdullah noted that a new trend of private funds have been established in the OPT, however, this trend is still in its very initial stages.

Dr. Abdullah mentioned that investment funds history goes back to 1822, first established by King William I, in Holland; and some historians suggest that there were even older experiences. Since then, investment funds have spread in number and diversity and have been playing a significant role in the market, providing various products, for supporting investments, especially in the IT field, and other equity funds.

Dr. Abdullah asserted that in the OPT, equity funds may be crucial to accommodate financing needs, particularly due to a limited collateral base, which may prove an obstacle for companies seeking loans.

Finally, Dr. Abdullah introduced the speakers who were invited to speak for this roundtable, for about 10-12 min each, followed by a discussion.

Mr. Bashir Assi

Mr. Assi provided a summary of the background paper prepared by MAS for this roundtable. The presentation provided a general overview of the market for investment funds in the OPT.

Mr. Assi started by defining investment funds, in general, as intermediaries for pooling investors money that are assigned to a professional investment manager, who invests the money in companies and securities. The main purpose is maximization of profits, and the investment horizon of private funds is usually for the long-term. In general, these private funds are not distributed to retail investors, but only to wealthy and sophisticated investors.

Mr. Assi added that the discussion would focus on two types of private investment funds: private equity and venture capital (that invest mainly in startup companies in the hi-tech sector). So far three funds have been established in the OPT: Abraaj, Siraj and Sadara (VC). In addition, the Welfare Association signed an agreement with OPEC Fund for International Development (OFID) for the establishment of a seed fund that will invest with young entrepreneurs. Mr. Assi asserted that the main objective underlying the discussion, is the development of companies in the private sector in the OPT. And for this reason two elements are important: efficient financing sources and business development capacities.

Most companies in the OPT are SMEs, and the main financing sources include: owner and family funds; bank loans; and other sources such as PIF, microfinance and holding companies. He added that the main problems in these financing sources are: the high interest rate on bank loans—more than 6% on JD and more than 11% on NIS; the high collateral requirements for bank loans; the limited debt capacity of these SMEs; political risk and other problems in judicial system. The development possibilities mainly include: improving the skills of employees, professional management, and expansion of the business regionally and internationally.

Mr. Assi specified the pros and cons of these funds, as follows:

Pros: On the *macro* level, these funds contribute to a more efficient allocation of resources and diversification, in addition to promoting innovation, especially by startups, which need private financing. On the *micro* level, the main point is that these funds invest in the shares of companies and by doing so, they share the company shareholders in both, the profits and losses; also these funds become involved with the management, putting together a business plan for the investee company; and finally, these funds can help developing the business of the company through their network.

Cons: These funds usually make their profits from exits, i.e. selling their shares in the investee companies to other investors after a certain period of time—e.g. 5-10 years—and this may cause conflicts of interest, between the funds and the management of the investee company and other stakeholders. In addition, their involvement in the business may limit the freedom of activity of the management of the company.

Therefore, in general terms, there is a tradeoff between “speed of growth” and the “freedom of action”.

As for the legal framework, Mr. Assi indicated that the Securities Law (2004) Article 2 defines investment funds, and the Palestinian Capital Markets Authority (PCMA) laid down Instructions (2006), for the (obligatory) registration of investment funds, but so far no fund has been registered. He added that the PCMA has the right to exempt a fund from the requirements of registration, based on Article 56, but the exemption criteria are not specified. And there is no distinction between funds that are distributed to professional investors and retail investors.

Mr. Assi pointed out that there are both opportunities and challenges faced by these funds. The main opportunities are: that these funds can become an alternative source of financing; they can help in developing the companies in the private sector; and can attract foreign investments. On the other hand, the main challenges, include: lack of awareness and trust in these funds (backward business culture); outdated laws and inefficient bureaucratic services and taxation.

In order to develop a sound and well-functioning private funds sector, Mr. Assi asserted that it is essential to: (1) foster competition, that may induce fund managers to decrease their fees, improve their services, and avoid concentration of control of companies in the hands of few funds, and (2) put together a set of high standards of best practices, possibly by a self-regulatory organization (SRO), in order to ensure high level of services, to improve the awareness, and to encourage long-term and sustainable investments. Finally, he asserted the need to (3) to improve the legal framework including IP laws, and the rule of law, in specific, the mechanisms of dispute resolutions.

Mr. Fayez Hussein

Mr. Hussein's presentation focused on private equity and their investment strategy. He first pointed out that by definition, private equity investment is done through investing in the equity of the company, for a medium to a long-term period (between 3-7 years), that ends at the exit of the fund, according to what has been agreed with the investors in the fund.

Mr. Hussein asserted that the purpose of the fund is to increase the value of the company, e.g. 4 or 6 times, through developing the company, improving its technology, expanding its business within the market or to new markets and even acquisition of other companies. The types of private equity investments include investment in family companies (family and friends), which are the main prototype of companies in the OPT. He added that each fund has a specific purpose, for instance, Abraaj Capital focuses on buyouts in general, while the RED platform focuses on growth, but no VC.

Mr. Hussein noted that, in general, companies usually start with family money, then they move to the stage of angel investor, then to venture capital (the stage after the idea has been developed), then to private equity when the company is already operating and there is growth potential and a need for additional capital (which is the financing strategy of the Palestine Growth Capital Fund (PGCF), and the last stage is the buyout—purchasing the whole company, and finally exit.

He provided an example of Maktoob company: it started with few investors who invested in the company with the founders, then a VC invested in the company, then in the stage of expansion, Abraaj Capital invested in the company, and after reaching a maturity stage, the company was sold to Tiger Fund, which later sold it to Yahoo, that bought Maktoob for consolidation, as they wanted to have a website in Arabic, so instead of creating a new company they bought a ready one. All the investors in all stages generated some returns.

Mr. Hussein attested that the main principles for the success of a fund are:

- ✧ The team (the fund and its management): their experience (local experience), track record—generated profits from previous investments—and their ability to identify potential investments in the market- pipeline;
- ✧ Investment decision making: methods of evaluation, due diligence etc.;
- ✧ Deal structure: the investment share, value, fees, governance, exit etc.;
- ✧ The management of the investment: active involvement in the investee companies, and planning the business development and expansion, until the exit.

The period of investment depends on the final decision of the a risk management team, who follows the deal in all its stages and has the final say, and they can decide to cancel the deal just before signing.

The main focus of the funds in the OPT is on SMEs (small and medium enterprises) and SMCs (small and mid cap companies). Today, investors are convinced that since 2008, after the crisis, there should be more focus on SMEs that could be developed from a VC stage and so on (a shift from buyout investments). In our region, 29% of the GDP is contributed by SMEs, and in terms of employment they contribute about 72%. Therefore, there is an opportunity resulting from lack or deficiency in investments in these companies. As for the PGFC, the initial idea started together

with the PIF, and in August 2010, a team was appointed, and came to the OPT. In December, the office was established, and in February 2011, the first fund was closed with \$36m out of \$50m. So far the team has examined more than 50 deals, and closed two deals, and two are in process.

Since the local market is limited, the potential of SMEs can be realized through the expansion of a business, developing its production, appointing professional management, and improving its governance.

As for the deal model, it is as follows:

- ✧ Investment term, between 3-7, depends on the type of company, its production, growth potential etc.
- ✧ Active involvement in the management, even if it is a minority stake, it is usually an influential minority. There is a shift in control, the fund managers become partners in capital and in the decision; and the investment agreement specifies some 'reserved' matters that require the fund co-decision.
- ✧ Improving the governance and institutional side of the company. Imposing a C-level, at least a CFO, that cannot be fired without the fund agreement.
- ✧ Cooperation with the company to help in its expansion in the region and globally.

To sum up, the fund becomes part of the management board, utilizing its network to help the company expand, and build synergies between the companies. The fund must institutionalize the company. Otherwise, it will not be possible to sell it to other investors. The fund also tries to improve the qualifications of the human capital, and the quality of reporting and auditing in the financial reports.

Mr. Husseini noted the main *challenges*:

- ✧ The number of companies, which are ready to be in the pipeline is small.
- ✧ Most businesses have family oriented mentality.
- ✧ Average investment is low- \$1m-\$1.5m (no \$10m deal); however, the deal process is the same, so the same time and costs.
- ✧ No governance and adequate standard of reporting (forecasting and planning) in companies, so we have to reorganize all these issues.
- ✧ The political uncertainties: according to the investment agreement the investor can stop its investment, according to the principle of capital preservation.

The main *enablers*, are the following:

- ✧ To improve awareness about private equity. For instance, in Jordan there is the highest number of internet investment in the region.
- ✧ Companies should be more receptive PE investments independently, i.e. corporate governance and institutionalism;
- ✧ Eco-system: in order to help the funds build a pipeline.
- ✧ Bank relationship and lending: banks should become more confident in granting the investee companies loans, and observe positively the fund investment, reporting and due diligence process. Banks ask us to be a guarantor, which is impossible for us as a fund, and as a board member.
- ✧ Policy and regulation: facing difficulties with current legal rules. For example, our investors require the fund to be an offshore entity, which is forbidden from owning 100% of a local company, according to the current regulations. So the fund asked for permission from the Ministry of Commerce, and was awarded an exemption. Receiving a general exemption, however, and not having to jump through so many hoops in every single deal would prove far more efficient. The same happens with the land registry bureau, as they need to check us for security reasons (as a foreign entity) each time we want to purchase a land. This takes time, about 6 months, and delays the deals. So we asked for an option for faster service, for which we pay approximately NIS 600.

- ✧ Taxation: finally, Mr. Hussein pointed out that they have been hearing about the possible cancellation of tax incentives, which may discourage investment activity in the OPT.

Ms. Abeer Hazboun

Ms. Hazboun gave an overview of the ICT sector, its future prospects, the challenges faced, and ended her presentation with recommendations for improving the readiness of the companies, in this sector, for investments.

The ICT sector in the OPT started in the 90's, and there has been a significant growth towards the late 90's, and developed to become an independent economic sector in the OPT, especially, since 2008 and onward. With growth rate of 8% in 2009, and 10% in 2010. An overall economic value added of around \$600m, 7% contribution to GDP, 6% of total services export. In addition, it is known to be a highly productive sector, as the average output value for a worker in the ICT sectors is about \$40,000, compared to the overall average of workers output of \$17,000.

In terms of education, there are around 13 universities teaching IT related topics in the OPT, with around 2,500 yearly graduates. Estimates suggest that only around 30% of these graduated get employed in the ICT sector (but there is no accurate information).

Almost half of the companies work in outsourcing, software development, consulting and online services.

Ms. Hazboun pointed out that the importance of the sector is its dependence on the main resource in the OPT, i.e. the human capital. And due to the gateway to the Middle East market, employee loyalty, talent, capabilities, language skills etc. local companies were able to interact with international companies. Around 50% of the companies have partnerships with foreign companies, 30% export services and products, major R&D projects with multinationals, e.g. Cisco, Intel and HP. The international market of this sector is concentrated in US, Europe, Canada, Middle East and the Gulf.

The sector has received some attention, by big companies, and has been mentioned in several newspapers, including Guardian, New York Times etc.

The sector has reached a stage of a steady point, and it is necessary now to build a strategy for the next stage.

PITA has put forth a strategy, after consulting all the stakeholders and examining the experience of other countries, e.g. Egypt, Jordan, India and Singapore. It has been realized that the Indian model will not work in the OPT, and all the stakeholders agreed that the strategy should be directed into innovation, in order to be able to develop this sector. So PITA's vision is to become: "A nation nurturing innovation and contributing to world knowledge"; and PITA will "lead the sector towards an innovation-based economy".

Ms. Hazboun identified the main challenges, as follows:

- ✧ Policy and regulations:
 - Intellectual property rights- needs to be developed;
 - Telecom regulatory body- organization of the telecom sector. There has been significant development in opening the market for internet service providers, but still there is a place for improvement;
 - IT infrastructure: to develop the infrastructure in order to improve competitiveness, decrease prices and benefit both consumers and the enterprise;
 - Business environment: the Palestinians are ranked #131 in ease of doing business, #177 in starting a business, and #183 in resolving insolvency. PITA has been working on these issues and has a project in cooperation with ICI (Investment Climate Improvement-USAID).

- ✧ Talents:
 - Although, there are good talents, some development is needed, in addition, to the creation of employment opportunities, while considering global trends. It is important to improve the employability and R&D in cooperation with the universities.
- ✧ The readiness of companies for investments:
 - To work on a strategic level. To consider the local and international markets and to assess where the local industry can add value, in which fields, e.g. mobile, outsourcing etc.. One problem facing investors when they examine companies, is the lack of focus, many companies do several things together, with no focus on certain field. The focus is important, as it helps in building the capacity of the companies based on demand.
- ✧ Image:
 - There is some lack of confidence from international parties in the ability to build a local IT market. Therefore, we are trying to develop a branding strategy for the sector, to show the success stories and the fields we can contribute to.

Finally, Ms. Hazboun ended her presentation with the following recommendations:

- ✧ To improve awareness on the importance of investments on the firm level and economic level.
- ✧ To support entrepreneurship: to foster the development of angel funding, which will develop the startups to the VC funding stage.
- ✧ Capacity building for businesses, in terms of business skills, strategic planning, specialization.
- ✧ Collaboration: to build a collaborative culture between universities, excellence center, incubators, investors, PITA and government. There needs to be a constant dialogue to learn about the weaknesses in the sector, in order to fill the gaps.

Discussion summary

Mr. Maher Masri- Palestinian Capital Market Authority (PCMA)

Mr. Masri indicated that in the background paper there is confusion, as the paper deals with private equity and venture capital, while the legal framework that is referred to relates to mutual funds. He asserted that private equity and venture capital are not supervised by the PCMA, and this point should be clarified.

Mr. Mohammed Kraish- Palestine Economic Association

Mr. Kraish suggested that there is a need to establish an institution that includes members from the PMA and other authorizes, that will be responsible to identify all the problems facing the investment participants. He indicated that he would like to see more focus on the effect of the funds activities on the Palestinian economy.

Dr. Atef Alawni- Bank of Palestine

Dr. Alawni pointed out that the background paper has a methodological problem in terms of mixing between the mutual fund legal framework and equity fund. Second, he suggested to focus on education and awareness about all types of investment funds, and to improve it in all generations. Thirdly, he raised some concern that these funds are concentrated in the hands of few wealthy families and big companies in the OPT, and therefore, the local businesses are afraid of these funds.

Dr. Fathi Srouji- Birzeit University/MAS

Dr. Masrouji emphasized the importance of investments and its added-value in terms of economies of scale; while indicating that in terms of diversification, and considering that the main segments of the economy, are infrastructure, industry and agriculture, he commented that the industrial and agricultural sectors are not receiving sufficient investments.

Mr. Iyad Jodi- Huloul

Mr. Jodi noted that in terms of pipeline, and although the companies may not be ready yet, but maybe the funds should invest in CSR programs to improve the company's readiness. The main problem is lack of exposure. As for angel funds we have few initiatives, but more is needed.

Dr. Iskandar Najjar- Al-Quds University

Dr. Najjar suggested that funds must take higher risks considering the local conditions, and whether we would benefit more from mutual funds rather than private funds.

Mr. Faied Rayan- Palestinian PCBS

Mr. Rayan had several remarks.

First: there have been three conferences on investments, and an initial evaluation summarizing the outcomes of these conferences. Therefore, he wondered what is the impact of this evaluation on investment funds. One of the main conclusions of these conferences was the significance of two points: networking/connectivity and stability; but the point that there are issues with the banking lending and relationship was not raised. There is an organization specializing on investments, called PIPA, that can provide information on available investments, this could attract both the local investors and investment funds, as well as foreign investors.

Second: He questioned the contribution of the funds to economic development, whether the current investment funds are focusing on creating new projects/ventures, capturing existing companies, or sharing in existing enterprises. Obviously, profits are the main driver for investments, but it is important to study this issue.

Third: according to the statistics of the PCBS, there are \$2b of Palestinian funds abroad and \$2.5b of foreign money invested in Palestine. Suggesting that more Palestinian money should be invested locally, and more foreign money should be attracted.

Mr. Jammal Haddad- Palestine Investment Fund (PIF)

Mr. Haddad indicated that there no objection against establishing new funds, but there is a problem of opportunities for investments, mainly, resulting from lack of awareness, and lack of openness to partnering with external investors, due to the family oriented businesses and mentality.

Mr. Nidal Zahran- Leaders

Mr. Zahran noted that they are working together with the Welfare Association and are currently trying to utilize the seed capital fund that has just been established. He suggested that the effectiveness of the involvement of an NGO as an investments vehicle in the private sector should not be doubted. Indeed, investment funds and their management are tuned to the private sector structure and needs. However, the problem of the pipeline will not be solved by the PE/VC, since their minimal investment is still high, which leaves a gap in financing that cannot be resolved by the owners or private funds. Therefore, the seed capital might help the smaller ventures to finance their operations for a short term period of several months, to help them reach to the stage of VC potential investment. Additional solution, is through the accelerators. For all these reasons, he indicated that it is important to work on a non-profit basis, and our success depends the mentality of the management of NGOs.

Mr. Mesyef Mesyef- Ministry of Finance/UNCTAD

Mr. Mesyef wondered why the local ICT sector does not provide services to the public sector and government offices.

Mr. Tareq Ma'aya- Exalt Technology Ltd.

Mr. Ma'aya emphasized that there is a need to separate between the telecommunication sector from the ICT. The telecommunication companies are services providers, like a bank. These companies do not innovate technology. Therefore, considering this the IT sector has a very small in the GDP, and there are no more than few hundred employees employed in his sector. Mr. Ma'aya also criticized the lack of government involvement, and indicated that the government did not employ the services of the local IT sector, and instead employed the services from foreign companies. Additional criticism was directed to the currently active funds, indicating that there are certain reservations towards each fund, and therefore, these funds are not supposed to reflect the real potential. In addition, there is a problem in the pipeline, which will not be resolved through investing money. Finally, our disconnection with the outside world should be resolved, and we

need to be more attentive to the global needs, and for this we need to work on the education level and communication with the world. He ended by pointing out the existing opportunity with the internet, as this does not need any physical connection with the rest of the world.

Mr. Maher Masri- PCMA

Mr. Masri mentioned that the Ministry of Economics built its IT system and programs (companies registrar, archives etc.) internally and with support of local companies, and the system is still operating effectively.

Speakers responses

Mr. Fayez Husseini asserted that there is no need for additional regulatory supervision by the PCMA. The supervision on the private equity is usually on the manager, in our case in Dubai, where the fund management is established, and by the offshore regulator where the fund is registered, and there is supervision by the regulator that supervises the investee company, and finally, by the investors.

In terms of policy, he added that they were able to obtain the necessary licenses relatively easy. But it would be helpful to get a general exemption by the regulators for the funds, if they meet certain criteria. The same with respect with the land registry office.

In addition, he responded to the point raised about concentration of money in few funds, that they have several investors, like EIB, CISCO etc. (Dr. Atef Alawni, responded that he meant that this information should be passed on to the people to increase awareness).

As for diversification, he mentioned that they do not invest in real-estate. Their first investment was herbal planting company, that was developed to the maximum extent, and this company is working without electricity and water; while the second was games company in Jerusalem; suggesting that they did not go for the usual suspects, and did take risks.

Moreover, he pointed out the importance of opening pension funds, more crucial than mutual funds.

As for pipeline, he mentioned that from the 50 potential companies that they have examined some will come back, once they see their success with other companies, and some are getting ready with their business standards and reporting. Emphasizing the point that they have the duty to improve the standards in the private sector.

As for the fear of controlling investments, he pointed out that they do not aspire to control companies, but rather to acquire an influential stake. General experience shows that family businesses start declining in value in the 3rd generation, unless they partner with other investors. We help companies develop and expand, and therefore, the owners of the company profit equally. In addition, the various types of funds buy shares in companies in different stages, considering that there is another investor that will purchase the company in a later stage.

He indicated that banks not only did not invest with them, but they are not easing the lending conditions.

As for investment in solar energy, he explained that Abraaj investments are in soft infrastructure-products purchased directly by consumers. Although, many investments are currently directed to green oil & gas, they have only one project with another Emirate company, USAID and the Japanese government to invest in solar panels for agriculture. But other than this, investing in solar energy is considered green, and it is in their focus.

Ms. Abeer Hazboun agreed that there might be a sufficient amount of funds, and there have been several visibility studies conducted, and therefore suggested that a further dialogue and a

reexamination of all the studies should take place, in order to see how it would be possible to utilize them.

As for entrepreneurship, she raised once again the lack of strategic direction, and this leads for a weak movement, emphasizing the need for additional seed funding. Finally, regarding talent, she mentioned that they are implementing a project funded by Google, but it is not sufficient. Lastly, she mentioned a need to improve the role of universities, through policy level intervention.

Mr. Bashir Assi explained that there is no exemption in the law and instructions for private equity and venture capital, and suggested that this point should be reviewed again. He mentioned that in other countries there are exemptions in the mutual funds laws—to which private equity can fall, e.g. based on number of investors and investor's profile.

Mr. Fayez Hussein responded to a question on comparing local funds with other funds in the region, that they are very small in size. But the problem in the Gulf is that there are no sufficient investment opportunities. Till now the OPT has been considered a charity case for the Gulf funds. In terms of returns he responded that they still have no experience.

Ms. Abeer Hazboun explained that there are many corporate social responsibility (CSR) investments and innovation but it is important to examine whether the benefits from these investments and how to steer them in the right direction.

Recommendations:

- ❖ Improving the awareness of business on the value investment funds activity, as an alternative financing source and business development catalyzer, for the private sector. This is critical considering the fact that most companies are SMEs and family businesses.
- ❖ Improving the legal system and the public institutions rules and bureaucratic procedures in order to foster the activity of private funds.
- ❖ Building a strategic plan for the development of ICT sector, including: the development of a pipeline, seed and angel funding, education and collaboration between all parties, including: ministries, universities, market participants, R&D centers etc.

The Palestinian Private Investment Funds: Challenges and Opportunities*

1. Introduction

1.1 The Issue

Can private investment funds support the private sector in the OPT, and provide local businesses and start-up companies with the necessary financing needs and business development opportunities? This background paper discusses the emerging trend of private funds, the pros and cons of these funds, their advantages on other traditional financing sources, and whether these funds can become a viable financing source in the OPT.

1.2 Setting the Scene

Promoting the private sector in the OPT in general, and the ICT sector in particular, has been repeatedly recognized as a priority concern by policymakers, and as a driving force for growth in the Palestinian economy. Two main factors are crucial in this respect: efficient financing sources and business development capacities.

While there are several funding sources that private businesses usually resort to—ranging from family-owned funds, bank loans, and investments by local and foreign entities—private funds can provide both, an alternative financing source and an engine for business development.

With both the limited sources of debt financing in the OPT, (mostly provided by family and community sources and commercial banks), and the limited debt capacity of local businesses¹, which are mainly family owned SMEs², equity financing by private funds can be a more efficient source of capital. Moreover, these funds possess the necessary capacity—in terms of business knowhow, expertise and networks—for promoting local businesses, and opening up new opportunities in terms of business development, competition, innovation, and expansion for new markets. This is particularly essential for start-up companies.

In the last few years, the pioneers of the yet underdeveloped private funds industry in the OPT have been showing up, and have assisted local businesses with their financing needs and managerial challenges. So far three equity funds have been established: the Palestine Growth Capital Fund (PGCF)³, SIRAJ⁴ and SADARA⁵. In addition, the Welfare Association has just signed an initial agreement with OPEC Fund for International Development (OFID) for the establishment of a \$300,000 seed fund aimed at supporting start-up companies and young entrepreneurs with their business development and financing⁶. Nevertheless, the private funds activity in the OPT remains so far marginal.

Notwithstanding the potential added value of private funds, there are several challenges and impediments that these funds are currently facing. Aside from the obvious political challenges—resulting mainly from the occupation, there are various local challenges and institutional and legal

* This is a preliminary draft, please do not cite or quote.

¹ The debt capacity is particularly limited for start-up companies, which can generally rely on equity investments only, see also MAS: Atyani, N. & Al Haj Ali, S. (2009). *Problems of Micro, Small and Medium Enterprises in Palestine*. Ramallah (Arabic). P. 61

² The World Bank (2012), *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*. Available at: <http://siteresources.worldbank.org/INTWESTBANKGAZA/Resources/GrowthStudyEng.pdf>. p. 90.

³ PGCF is a private equity fund established in 2009 by the Palestine Investment Fund (PIF) in partnership with Abraaj Capital, a \$50m fund focusing on the Palestinian SMEs sector. Additional investors in the fund include, Bank of Palestine, the European Investment Bank and CISCO company, see <http://www.pif.ps/index.php?lang=en&page=12741824011452>.

⁴ SIRAJ is a private equity fund that belongs to Massar International Holding Company, launched in 2011, see <http://www.siraj.ps>

⁵ SADARA is a venture capital fund, launched in 2011 investing in the ICT sector, see <https://www.sadaravc.com/>

⁶ <http://www.alquds.com/news/article/view/id/386794>

obstacles that need to be resolved, in order to allow for the building up of a sound and active private funds industry.

The following sections present a more elaborated overview of these challenges and obstacles, that are facing the private funds industry in the OPT.

1.3 The Pros and Cons of Investment Funds

Investment funds are pools of capital assigned by investors to professional money managers, who invest the assigned capital in a portfolio of assets, aiming at maximizing returns for the investors.

Private equity and venture capital focus on equity investments in privately held companies (unlisted companies). They invest in companies with relatively high level of risk and a long-term investment horizon. They become co-owners in the companies, sharing risk and return⁷. Private equity investors are more generalists, while venture capital invests mainly in early stage ICT companies. Those funds usually commit their money for a medium to a long-term investment horizon. Many of these funds have been investing heavily in developed markets as well as emerging market and underdeveloped countries, searching for high-yield investments. Such investments include companies with potential growth, companies that lack effective management, and distressed companies. Most of these funds are registered in offshore jurisdictions, permitting them to benefit from a favorable tax regime and regulatory requirements⁸.

Investment funds vary in size, structure and complexity. One main distinction is between publicly traded and privately held investment funds. Other classifications are based on different elements, such as, the investment strategies, types of assets, legal structure and else. Private funds differ from sovereign wealth funds in that private parties hold the former, while the state owns the latter.⁹ Private funds also differ from holding companies in that they hold smaller stakes in the investee companies; while holding companies acquire mostly controlling stakes

Pros:

The main added values of investment funds to the economy, aside from being a source of capital, include:

Macro level

- ✧ Professional allocation of investments and diversification. These funds can also provide professional investment management services, for both retail and institutional investors (e.g. insurance companies and pension funds), fostering more investments in the local private sector, by domestic and foreign investors, and enhance households' savings.
- ✧ A driving force for innovation and economies of scope, particularly at the level of start-up companies.

Micro level

- ✧ Profit/loss sharing, instead of only increasing the debt of the investee company;
- ✧ Proactive involvement in the business and professional business management and development (business plan, financial reporting etc.);
- ✧ Assisting the private sector to reestablish its connections with regional and global markets, creating opportunities for regional and international expansion and cooperation, through their global networks¹⁰.

⁷ See Cooke, D. J. & Daw, J. (2004), *Private Equity: Law and Practice*. Thomson: Sweet & Maxwell. P. 3

⁸ See Spangler T. (2008), *The Law of Private Investment funds*. Oxford University Press.

⁹ The largest public fund in the OPT is the Palestine Investment Fund (PIF), established in 2003 as public company, supporting projects in real estate, finance, industrial, telecom, power and energy sectors, with approximately \$800m AuM, of which around 80% invested in Palestinian entities, see <http://www.pif.ps> see also Economic & Social Monitor (2011), Vo. 25, p. 41.

¹⁰ In the recent report by the UNCTAD it was indicated that this isolation of Palestinian producers led to their "inability to procure production inputs and to export their goods and services." ¹⁰ UNCTAD (2012), *Report on UNCTAD assistance to the Palestinian people: Developments in the economy of the occupied Palestinian territories*. P. 4. Available at: http://reliefweb.int/sites/reliefweb.int/files/resources/tdb59d2_en.pdf

Cons:

- ✧ Focusing on exit: private funds returns materialize with their exit, i.e. selling their shares in the investee companies, which might create conflicting interests with the rest of the shareholders, in terms of investment horizons.
- ✧ Imposing constraints on the management of the investee company and a strict business plan.
- ✧ In the case of leverage-buyout investments (LBOs), private equity might significantly increase the debt burden of the company, which might increase the risk of failure.

1.4 Financing Sources in the OPT

Most Palestinian businesses rely first on family resources, in addition to bank loans and foreign investments. Family and personal resources of capital constitute more than 75% of business funding. Bank loans amount to no more than 10% of the private sector financing needs¹¹, and most enterprises- mainly medium sized companies, face difficulties in obtaining bank loans¹², and providing adequate collateral¹³.

In recent years there has been a significant decline in foreign aid and donors support to the OPT, around 27% decline in 2011 compared to the previous two years, which had a detrimental impact on the Palestinian economy¹⁴. This decline in foreign aid has resulted in draining public resources and has indirectly affected the business activity in the OPT (e.g., less fiscal spending, increase in tax rates and increase in prices)¹⁵.

According to the Palestine Monetary Authority (PMA), in 2010 the total foreign investments in the OPT amounted to \$3,340m, of which \$2,297m were invested in banking and other private sector, and \$1,378m are direct investments¹⁶ (investments that exceed 10% of the voting power in an enterprise)¹⁷. Moreover, overall foreign investments in Palestinian institutions have increased during the years 2008-2010, from \$1,343.8m in 2008, to \$1,586.1m in 2009, and \$2,297m in 2010¹⁸. This shows that foreign investment activity in the OPT have a significant potential and should be encouraged.

On the other hand, the total external assets (Palestinian investments abroad) reached \$5,424m in 2010¹⁹. Although, it is logical that most Palestinians search for ways to secure their own money by purchasing foreign currencies and depositing their money abroad (\$3,269m out of the \$5,424m are in currencies and deposits), one can presume that part of these amounts could have been invested instead in investment funds that can provide more professional money management services, at the same time invest in local businesses.

To this date, asset management in the OPT remains marginal. Insurance companies and commercial banks²⁰ did not invest in professional asset management departments (and investment

¹¹ MAS: Abdelkarim, N. (2010). *Towards Policies that Stimulate Adequate Financing to Small and Medium Size Enterprises*. Ramallah (Arabic). P. 49

¹² The interest rates charged on loans by banks in the OPT are still high; based on data published by the PMA, the average interest rates for 2011 were: 7.59% (JD), 6.79% (US \$), 11.72% (NIS), available at: http://www.pma.ps/index.php?option=com_content&view=article&id=192%3Astatistical-banking-data&catid=115%3Abanking-data&Itemid=85&lang=en

¹³ The World Bank (2012), supra note 2, p. 116.

¹⁴ UNCTAD (2012), supra note 10, p. 7.

¹⁵ The World Bank (2012), supra note 2, p. 7.

¹⁶ The difference of \$1,043m was invested in the government sector, see table available at the PMA website: http://www.pma.ps/index.php?option=com_content&view=article&id=219%3Afirst-ever-preliminary-results-of-the-international-investment-position-for-the-palestinian-territory-2010&catid=37%3Apress-release&Itemid=107&lang=en.

¹⁷ OECD (2008), *OECD Benchmark Definition for Foreign Direct Investment*, fourth edition 2008, available at: <http://www.oecd.org/fr/daf/investissementsinternational/statistiquesetanalysesdelinvestissement/oecdbenchmarkdefinitionofforeign-directinvestment-4thedition.htm>

¹⁸ See Economic & Social Monitor (2010), Vo. 22, p. 49.

¹⁹ Ibid.

²⁰ Banks investment in affiliated entities/companies amount to 1.5% of the banking assets in the OPT, according to Economic & Social Monitor (2011), Vo. 28, p. 42. In addition, banks allocate around 9.1% in money market instruments and securities. This indicates that banks investment in local companies is still marginal.

banks are nonexistent), and no private pension funds have been established yet²¹. Local commercial bank investment in foreign assets reached \$3.8b in 2011, of which \$826.8m are portfolio investments, while only \$137.36m are in local portfolio investments²². Most financial assets and companies have been privately held by wealthy families, high-net-worth individuals, and holding companies (a more recent development of managing the money of wealthy families more professionally).

Considering all the above, the establishment of the few private funds in the last years is an important development. It seems that the absence of a developed professional investment management sector is a missed opportunity, as the local market consists of mostly SMEs and family businesses, of which many have inherent growth potential. However, these SMEs have limited access to affordable finance, and in some cases borrowing money from banks might be difficult, due to the high-level of collateral requirements²³. Therefore, many SMEs might be favoring equity investment, suggesting that there is a place for improving the effectiveness of management and for fostering technology-based industries.

Moreover, allowing private funds to be active in the OPT without facing any major obstacles, can provide both individuals and institutions with a more professional investment management services, and can stimulate foreign investments inflows, as those investors have more confidence in internationally experienced and professional asset managers.

2. Opportunities and Challenges

2.1 Opportunities

There are various opportunities for advancing the private sectors, agriculture, industry (e.g. stone cutting), and ICT²⁴, while current indicators show that private sector investments in the OPT are still low²⁵.

Although the local private sector development might have been limited due to the relatively small size of the domestic market, the occupation, and the limits in natural resources; it is worth emphasizing that the highly skilled human capital and expertise constitute an opportunity for the expansion of local businesses to new markets and new sectors, and the development of domestic high value production²⁶, e.g. hi-tech industry.

In addition, investment funds can more professionally manage and provide a more efficient allocation of institutional and public money and household savings. In this context, according to the Palestinian Monetary Authority (PMA) 29% of public deposits are in saving accounts and 31.2% are in time deposits, amounting to \$2.03b and \$2.18b respectively (out of \$7bn of total deposits), at the end of 2011²⁷. The saving accounts are usually deposited in accounts with no or very low interest. Clearly, due to the political instability in the OPT, most individuals prefer to

²¹ There have been some initiatives to establish private pension funds, but so far these initiatives have not materialized, see the World Bank (2012), supra note 2, p. 115. For comprehensive studies on the need for private pension funds in the OPT see Dr. Atef Alawneh (2011), *Pension Reform in Palestine*. Bank of Palestine; and The Portland Trust (2007), *Developing a Private Sector Pension System in the West Bank and Gaza Strip*. Available at: <http://www.oecd.org/site/iops/research/49333349.pdf>

²² See Consolidated Balance Sheet of Banks Operating in Palestine, published by PMA, available at: http://www.pma.ps/index.php?option=com_content&view=article&id=187&Itemid=142&lang=en

²³ The World Bank (2012), supra note 2, p. 116

²⁴ See also PIPA (2010). *Investment Guide in Palestine*. P. 114-118, also the World Bank recommends investment and development of hi-value production, the World Bank (2012), supra note 2, p. v.

²⁵ The World Bank (2012), supra note 2, p. v.

²⁶ Ibid, p. 94

²⁷ See Palestinian Monetary Authority (PMA) (2011). *Annual Report*, p. 90-92, available at: http://www.pma.ps/images/stories/annual_reports/annual%20report-2011.pdf, see also, Economic & Social Monitor (2011), Vo. 28, p. 45-46.

hold liquid assets, e.g. cash. Nevertheless, part of these sums can be allocated more efficiently into retail oriented funds, e.g. open-ended funds with frequent redemption rights²⁸.

And as a natural consequence, private funds activity can improve economic growth²⁹ and contribute to job creation in the OPT, which is currently suffering from high unemployment rates around 17% in West Bank and 28% in Gaza (an average of around 20%), in 2011³⁰.

In addition to all the above, it is worth mentioning that private funds, i.e. private equity and venture capital, are not subject to any registration requirements or other regulatory measures by the Palestinian Capital Markets Authority (PCMA). This constitutes an opportunity for private fund manager that are interested in establishing an active fund in the OPT³¹. Moreover, private fund managers do not fall under the regulated category of money managers and financial advisers by the PCMA, as the PCMA rules are confined to those whom deal with publicly traded securities³². To summarize, in the current legal framework, private fund managers (who invest in privately held companies) are not subject to any local authorization or registration requirements³³.

2.2 Challenges and Obstacles

The main challenges that are constraining the development of the private funds sector, aside from the occupation and the political instability³⁴, include:

- ✧ Lack of awareness and trust: the culture of the family oriented business and the lack of trust in delegated management and financial advisers are two challenges that the private funds industry should confront. Therefore, they should build up the confidence of the business community in the added value of their services and expertise.
- ✧ Outdated laws: corporate, bankruptcy/credit arrangements, secured credit and competition laws³⁵ need to be updated to allow for efficient business activity.
- ✧ Inefficient bureaucratic services: particularly in land registration³⁶.
- ✧ Taxation: if the fund is taxed it means that the investors are taxed twice, once on the fund level and again on the personal level, this eliminates all incentives of creating a fund, as purchasing shares directly would be taxed once only³⁷.

²⁸ IOSCO (2012), *Development and Regulation of Institutional Investors in Emerging Markets*, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD384.pdf>, p. 20.

²⁹ The World Bank (2012). *Fiscal Crisis, Economic Prospects: The Imperative for Economic Cohesion in the Palestinian Territories, Economic Monitoring Report to the Ad Hoc Liaison Committee*, available on: <http://siteresources.worldbank.org/INTWESTBANKGAZA/Resources/AHLReportFinal.pdf>, p. 4: “the sustainability of growth in the Palestinian territories depends upon increasing private investment”.

³⁰ See PMA, 2011 Annual report, supra note 27, p. 32-33, see also the World Bank (2012), supra note 2, p. 23-24, 122-125.

³¹ The PCMA has adopted Instructions for Licensing Investment Funds in 2006, those instructions apply only to ‘mutual funds’, both open-end and closed-end. The Instructions are based on the Securities Law, no. 12 for 2004; and are available on: <http://www.pcma.ps/securitiesSector/Pages/Instructions.aspx>

³² According to the Rules and Conditions for the Professional Licensing of Money Managers and Financial Advisers, money managers and financial advisers have to meet certain qualifications and are required to pass qualifying examinations for acquiring a license from the PCMA. These rules are based on the Regulation for Securities Companies, no. (1), 2006, available on: <http://www.pcma.ps/securitiesSector/Pages/Instructions.aspx>

³³ According to IOSCO report, of the 21 surveyed jurisdictions in emerging markets where private equity funds are active, only 13 regulate private equity funds, and only 10 of those require private equity manager approval. See IOSCO (2012), supra note 28, p. 14-15.

³⁴ See UNCTAD (2012), supra note 10, p. 10-12, “the key obstacles facing the Palestinian economy are all related to occupation”; see also the World Bank (2012), supra note 2, p. 20-21. Many of the restrictions on movement of goods, foreign trade and business activity stem from the economic agreement between the Palestinians and Israel, Protocol Paris, and unless this agreement is amended many of the current constraints will remain prevalent. In another recent report, the World Bank has emphasized in its recent report that “restrictions put in place by the Government of Israel (GoI) continue to stand in the way of potential private investment and remain the major impediment to sustainable economic growth”, the World Bank (2012), supra note 29, p. 4

³⁵ The World Bank (2012), supra note 2, p. 105-106; see also MAS: Milhem, F. (2010). *Improving Palestinian Investment Legislation to the Advantage of SMEs*. Ramallah (Arabic). P. 53-69

³⁶ The World Bank (2012), supra note 2, p. 20, 107.

³⁷ See IOSCO, 2012, supra note 28, p. 23, 28; see also the World Bank (2012), supra note 2, p.15, 83.

3. Developing a Sound and Well-Functioning Private Funds Sector

As indicated previously, unlike other financing sources, the private equity and venture capital approach is to invest directly in the business, rather than providing loans (which increase the debt of the company). This equity oriented investing strategy, provides for a more genuine cooperation, both in terms of financial risk burden (profit/loss sharing) and operational management. These factors increase the odds for the success of the businesses.

Nevertheless, there is some critique that private funds may disregard the long-term interest of the investee company and focus on their own short-term profits (so called, short-termism phenomenon), e.g. in the case of buy-out funds. This may lead to conflicts of interest with the investee company shareholders, managers, and other stakeholders; and may cause instability in the market, in the longer term. Therefore, policymakers and market participants should ensure that these potential failures are mitigated.

According to IOSCO recommendations³⁸, several factors are essential for the development of funds industry—most importantly in the capital market environment, i.e., investor protection, property rights, corporate governance; market openness; regulatory framework and financial stability.

In the case of the OPT, in order to promote a sound funds industry that adds economic value to the local market, while mitigating potential failures, the following important elements constitute the main objectives:

- ✧ Competition: a competitive market, both in the funds sector and in the local market in general, will induce funds managers to improve their services and charge lower fees³⁹.
- ✧ Best practices: high standards of best practices, preferably set by a self-regulatory organization (based on common international standards), will provide quality assurance and increase the awareness of the investee companies. Also the promotion of corporate social responsibility (CSR), and sustainable investments, can direct the incentives for the long-term growth of the market economy.
- ✧ Robust legal framework: proper regulatory measures that ensure the protection of property rights (including intellectual property, IP), investors' protection, healthy investment climate (including modern corporate, restructuring and bankruptcy, secured credit, and anti-trust laws).
- ✧ Rule of law: accountable dispute resolution mechanisms, through the judicial system or alternative resolution systems, to ensure a healthy business environment, the protection of rights, enforcement of contracts, and the ability to restore damages in the case of failure, e.g. fraud, misrepresentation, negligence of one of the parties. Currently, according to the Law for investments, in case of dispute the parties can turn to arbitration or court⁴⁰. According to the recent reports judicial performance in the last years seems to be satisfactory⁴¹.

In the current situation, efforts must be devoted for improving all the above elements.

4. Questions for Discussion

- ✧ What have private funds in the OPT achieved so far- in comparison with other traditional financing sources?
- ✧ What can be done in order to promote an active and diligent private funds management in the OPT; and resolve the legal and institutional obstacles?
- ✧ What adjustments should active fund managers adopt, in order to be more effective in answering the needs of the private sector in the OPT?

³⁸ See IOSCO, 2012, *supra* note 28, p. iv-v.

³⁹ See IOSCO, 2012, *supra* note 28, p. 21.

⁴⁰ Birzeit- Institute of Law (2010), *Business Law Guide*, p. 267.

⁴¹ The World Bank (2012), *supra* note 2, p 108.

**The Palestinian Private Investment Funds:
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October 1st, 2012**

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