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Cash Squeeze for
Kuwaiti Investment
Companies
*Strategies to
Stabilize and Create
Sustainable Growth*



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EXECUTIVE SUMMARY

Kuwaiti investment companies have been disproportionately hurt by the downturn in global markets, mainly because of a highly fragmented portfolio and a strong reliance on financing in instances where their cash flow is limited. This has left them vulnerable as lenders have retreated and restricted access to new debt. To recover, investment companies have to adapt to these conditions and make significant changes—both in their portfolios and in their approaches to financing.

In the short term, investment companies should focus on improving their cash position by rationalizing their portfolios to focus their efforts on fewer companies. They should also improve cash management at their holding and investee companies, as well as work with lenders to ease existing debt obligations.

Looking further into the future, we see a number of ways for investment companies to create sustainable, profitable growth. They must develop an explicit strategy to create value, and they must improve their governance and risk management practices to support the implementation of this strategy. They also need to set long-term targets for their portfolios and align their corporate finance capabilities with these targets.

KEY FINDINGS

- The global financial crisis has hit Kuwait especially hard due to the relatively high number of investment companies in its economy.
- Kuwaiti investment companies' fragmented portfolios, with small stakes in many companies, has limited their access to cash as well as increasing their costs.
- These companies must take steps now to extract as much cash as possible from their investments and reduce the pressures of short-term debt obligations.

THE FINANCING SQUEEZE

The global economic downturn has spared few investment portfolios. In Kuwait, though, the impact has been especially acute, because the country has approximately 100 registered investment companies (46 of which are listed on the Kuwait Stock Exchange) and several other industrial and real estate companies with large investment portfolios. Listed investment companies alone constituted about 20 percent of the total market capitalization of Kuwaiti listed companies at the end of the third quarter in 2008 and about 15 percent in 2009, a higher share than in most other industrialized economies.

As in much of the rest of the world, the crisis among Kuwait's investment companies stemmed from a misplaced belief in perpetual growth driven by unlimited access to liquidity. In this context, investment companies invested opportunistically in a large number of portfolio companies, often in minority shares of private companies. As an example, two of the five largest listed Kuwaiti investment companies own portions of a combined total of about 120

portfolio companies.¹ Many of those investments are made up of relatively small stakes (with carrying values as low as 5,000 KWD [US\$17,185] in some instances).

Fragmenting portfolios in this way doesn't just make investment companies' access to and monetization of cash less flexible; it also increases their transaction and management costs. In addition,

investment companies are limited in their ability to immediately monetize these companies because of the dried-up IPO market; investors have little interest in purchasing minority shares in unlisted equities. Portfolio managers have further reduced the liquidity of their portfolios by investing in private equity funds and real estate ventures. Monetizing these bets has proven difficult given limited exits in private

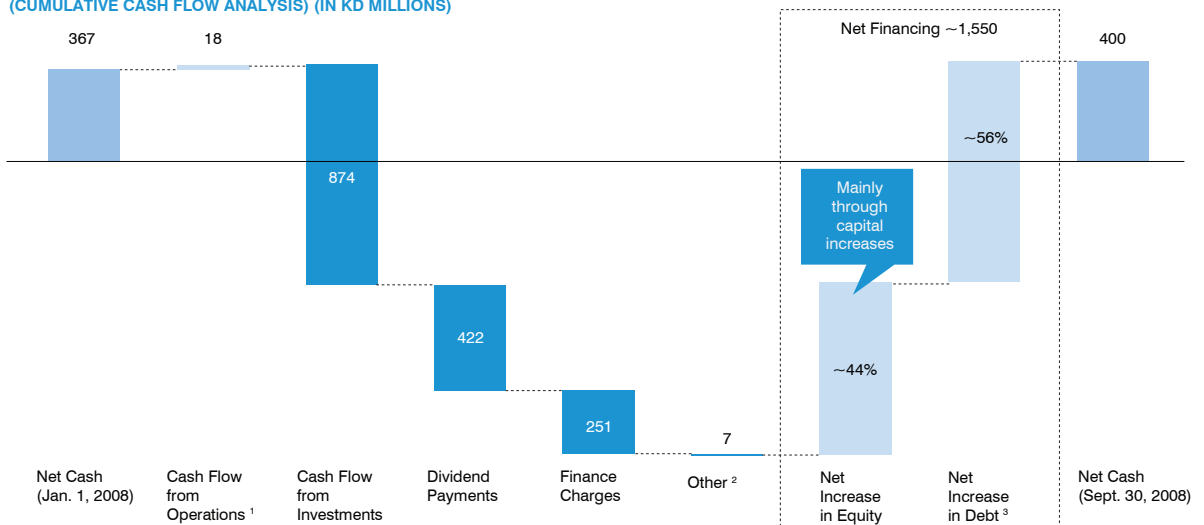
equity funds and delayed or canceled real estate projects.

Further, Kuwait's investment companies depended on the availability of liquidity to finance their growth and pay their shareholders. In addition to covering investment activities, they used a combination of debt and equity in 2008 to finance dividends and interest charges (*see Exhibit 1*). This practice

Exhibit 1

Kuwaiti Investment Companies Had to Raise Capital to Cover Financing Obligations in 2008, in Addition to New Investments

**LISTED KUWAITI INVESTMENT COMPANIES (EXCLUDING KIPCO)
(CUMULATIVE CASH FLOW ANALYSIS) (IN KD MILLIONS)**



¹ Adjusting for financing activities, where applicable, can increase net cash flow from operations by up to 42 million KWD

² Mainly consists of gains and losses from foreign exchanges

³ Split of net financing between debt and equity is based on balance sheet analysis of the increase in outstanding debt and shareholders' equity

Note: Figures based on analysis of 43 listed investment companies (three companies were excluded owing to unavailability of data)

Source: Company financial statements; Booz & Company analysis

exacerbated the squeeze on liquidity when stock markets plummeted and their retained earnings declined, forcing them to seek additional sources of financing to cover these expenses.

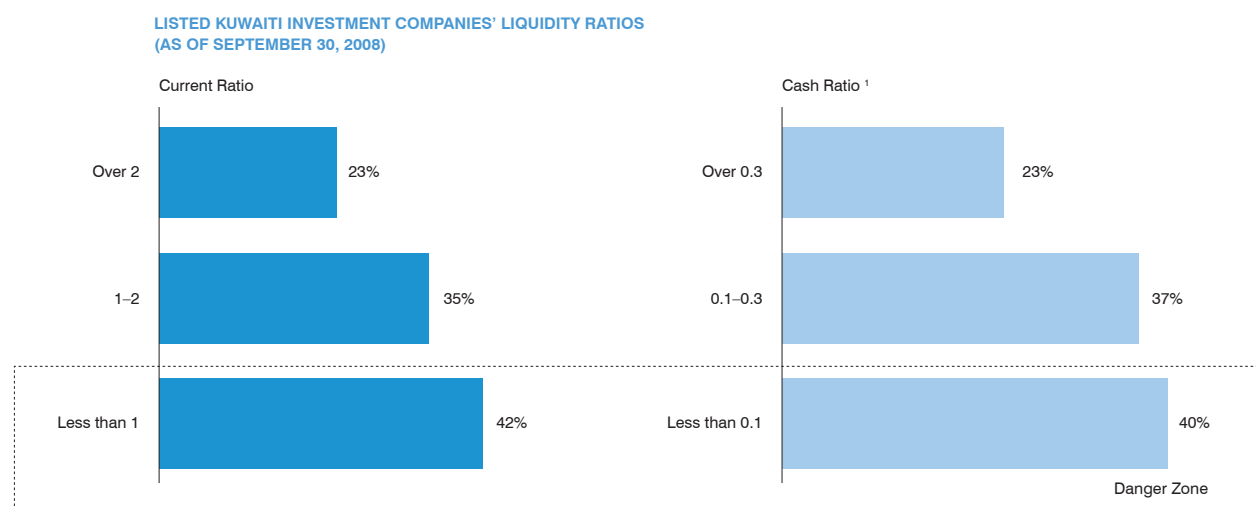
The average debt-to-equity ratio of Kuwaiti investment companies—around 1, including both short-term and long-term debt, as of September 2008—may look adequate, but the

companies' ability to cover financing charges is challenged. Finance charges for listed Kuwaiti companies totaled 290 million KWD (\$996.4 million) in the nine-month period ended September 30, 2008, while cash flow from operations and investing activities was negative.

Additionally, more than 75 percent of listed investment company debts are short term, which further accentuates

the problem given the long-term nature of their assets. More than 40 percent of investment companies have a current ratio below 1 and a cash ratio below 0.1 (*see Exhibit 2*). This could be dangerous if banks put additional pressure on investment firms to pay short-term debt, especially considering their limited opportunities to divest portfolio companies.

Exhibit 2
A Substantial Number of Investment Companies Are in the Liquidity Ratio Danger Zone



¹ Marketable securities excluded from cash ratio
 Source: Booz & Company analysis

IMMEDIATE STEPS TO STABILIZATION

Kuwaiti investment companies should act now to stabilize their cash flow, rightsize their capital structure, and build a foundation for sustainable profit growth. There are several actions companies can take in the short term to alleviate the cash squeeze and give themselves breathing room to consider longer-term fixes.

Rationalize the portfolio: In the short term, Kuwaiti investment companies should focus their human and capital resources on the portfolio companies that matter—those in which the investment company can create long-term value, generate short-term cash through dividends, and generate long-term cash through additional dividends or exit. During the rationalization process, it is important to target underachieving companies that are ripe for lower levels of investment, closure, or divestiture. Sale proceeds can be used to pay down debt or support more valuable investments. Companies should not be deterred by the possibility of exiting at

low valuations if they can put the proceeds to better use.

Improve cash management: Kuwaiti investment companies have to improve cash management at the holding and investee company levels. For the latter, investment companies should work directly with these companies to establish cost-cutting targets—for instance, through working capital improvement or operational cost improvement initiatives. This would enable investment companies to extract more cash from operations, especially in sectors where portfolio managers have insights gleaned through experience. Investee companies often do not have the tools or incentives necessary to effectively manage their capital.

Reducing or halting dividend payments in the short term, although not attractive to shareholders, is another viable option, especially now. There is no better time to find understanding investors. In today's

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economic environment, they will likely see such a move not as a sign of weakness, but as a responsible and necessary step to fortify the company's financial position.

Ease debt burdens: Investment companies should search for opportunities to lighten their debt obligations, either through renegotiation with their lenders or by shifting their debt burden to operating subsidiaries.

In this environment, banks realize they stand a greater chance of recovering loans by working with companies to restructure their debt. This is especially the case with investment companies, which took out approximately 40 percent of total debt held by all Kuwaiti listed companies (including the consolidated debt of subsidiaries and excluding all debt taken by financial institutions). Cash generated through improvement initiatives can be used to repay selected debt obligations. Such a move sends a positive signal to the lender that the company is committed to meeting its other obligations. As a result, the bank will likely be more willing to renegotiate the terms on other outstanding debt.

Where possible, investment companies can give banks greater confidence in their ability to repay their obligations by providing more transparency on how the debt is used and showing a clear action plan to improve their cash position. Banks gain greater insight into the company's ability to repay by being able to more closely track cash flows.

Not Just Their Problem

Regulators should not overlook the impact of Kuwaiti investment companies on the overall Kuwaiti economy. Listed Kuwaiti investment companies alone had approximately 6.9 billion KWD (\$25.8 billion) in debt (including consolidated debt of subsidiaries) as of September 2008, or the equivalent of about 30 percent of the Kuwaiti domestic credit portfolio as reported by the Central Bank of Kuwait. Although only a portion of this debt is owed to local banks—between 30 and 40 percent—a crisis with investment companies (both listed and private) could have a serious ripple effect on the banking sector.

Given that possibility, regulators should clearly articulate and quantify the depth of the problem and its effect on the Kuwaiti economy and prioritize the challenges to be addressed. Once priorities have been set, they should work closely with relevant investment companies to stabilize the situation and address the current cash squeeze. Following the immediate crunch, regulators should formulate a long-term strategy for the sector and define its role within the Kuwaiti economy. More important, regulators should develop the required policies and enhance their supervisory capabilities to avoid a repeat of the current problem.

STEPS FOR LONG-TERM SUSTAINABILITY

Once these short-term fixes are in place, investment companies need to focus on long-term sustainability to reduce the impact of future cash squeezes.

Develop long-term strategy: Critical to the long-term success of Kuwaiti investment companies is a clear definition of their strategic role. This will ultimately drive their value creation strategy, which must be aligned with the portfolio, operating model, and performance-management approach. Marked differences exist among investment companies, and strategy needs to be tailored to each organization's specific makeup. Broadly speaking,

the gamut runs from conglomerates that remain actively involved with the management of only a handful of investee companies to managed investment funds that spread their bets over more than 50 investments, with limited involvement in their day-to-day activities (*see Exhibit 3*).

Set portfolio targets: Kuwaiti investment companies have to define long-term targets for their portfolio mix to avoid being overwhelmed by the multitude of investment opportunities. Targets could be defined across multiple parameters, such as industry, region, type of investment, value creation approach, level of ownership, deal size, level of liquidity, and expected return. Targets should be continually challenged and reviewed with respect to shareholders' expectations, the market environment, and the holding company strategy. Companies should

also maintain some flexibility by setting aside a small share of capital for taking advantage of opportunistic investments beyond set guidelines.

Another important element to address in the portfolio composition is the investment company's level of influence on portfolio companies. Over the years, many Kuwaiti investment companies have made minority equity investments in private companies in hopes of listing those companies when they reach a certain stage of growth. When interest from potential buyers wanes, the investment companies are then trapped in a situation in which they cannot liquidate the assets or influence company strategy. Every effort needs to be made to ensure that minority shares are safeguarded by minority rights and other protective provisions.

Exhibit 3
Different Holding Companies Have Different Considerations

| | Conglomerates | Investment Holding Companies | Private Equity Firms | Managed Investment Funds |
|------------------------------------|---|---|--|--|
| Value Creation Strategy | Leveraging operational and financial synergies across businesses | Strategic guidance and access to privileged deals and/or superior stock picking | Strategic, financial, and operational restructuring | Optimal risk and return allocation |
| Involvement in Portfolio Companies | Work actively with management | Work mainly with board of directors | Work actively with management | Limit involvement (restricted to voting in shareholder assembly) |
| Number of Investments | Small (5-10) | Medium (11-30) | Medium (31-49) | High (>50) |
| Time Horizon | Very long term (>10 years) | Long term (7-10 years) | Medium and finite investment horizon (2-5 years) | Holdings are both short term and long term |
| Stakes in Portfolio Companies | Controlling stakes (often wholly owned) | Relevant stakes (5-50%) | Controlling stakes (>50%) | Typically small stakes (<10%) |
| Type of Equity Targeted | Mainly private equity | Both listed and private equities | Mainly private equity | Large share in public equities (>70%) |
| Operating Model | 50-400 corporate HQ employees with potential shared-services organization | 20-40 employees typically structured by investment value chain | 40-200 employees typically structured by sector or geography | 2-3 employees (portfolio manager+ analysts) |
| Typical Performance Measures | ROE, free cash flow, and economic value add | Net asset value growth and net asset value discount | Investment IRR | Sharpe index and returns vs. benchmarks |

Source: Booz & Company analysis

Develop appropriate corporate finance capabilities: Portfolio changes should dictate a change in the corporate finance strategy and capabilities at the holding level. Companies need to provide more transparency to lenders in the use of financing, as well as isolate the cost of debt and the risks faced by individual companies, by continuing to push down debt to the investee company level, where possible. In addition, they need to match the maturity of their liabilities with that of their assets. Doing so will require them to shift from a focus on short-term loans to the use of financing approaches aligned with the overall financing strategy and often with individual investments (i.e., project financing for real estate or infrastructure projects, or mezzanine financing for selected ventures). More important, holding companies with a high percentage of unearned income (or no operating assets) should avoid having excessive debt at the holding level.

In addition to making these changes, companies need to develop a long-term dividend strategy for the future. Any decrease in dividends, however, could have a negative effect on holding companies' share price. Kuwaiti companies should gradually educate investors about total shareholder return and reduce the pressure on holding companies to pay regular dividends. As an example, if an investment company depends significantly on unearned income until investments are monetized, it shouldn't be forced to maintain a consistently high dividend payout ratio. Instead, the dividend payout

ratio could be measured over a period corresponding to the average life of the company's investments. These changes, of course, require the development of strong talent and systems in corporate finance at the holding level, complementing the mainly accounting-focused capabilities present in many of the investment companies.

Improve governance and risk management: Thanks to the recent downturn, investors are highly aware of the importance of good governance. Governance is particularly vital for investment companies: Large and frequent investment decisions, conflicts of interest, cross-ownership, and subsidization among portfolio companies are a few of the issues that need to be addressed by an effective and transparent governance framework. For example, clarifying the role of the board and ensuring that directors have the right combination of financial skills and industry knowledge is a starting point to set an effective and realistic strategic course. Investment companies should also focus on improving communications with the chief financial officer and other C-suite executives in order to strengthen the quality of the information that board members use to make decisions and manage risks. Most important, the board should enforce the adoption of appropriate risk management practices (including stress-testing portfolios), forcing executives to evaluate decisions and monitor portfolios within a predefined risk/return and liquidity framework.

CONCLUSION

Kuwaiti investment companies face an imperative to alter their course as prospects for potential exits dry up and new financing remains elusive. With their investee companies unable to generate enough cash on their own, portfolio managers simply cannot afford to wait any longer for a market rebound.

Instead, they will benefit from taking a firm hand now to extract as much cash as possible from their investments and reduce the pressures of short-term debt obligations. Taking careful steps to develop a clear value creation strategy, setting long-term portfolio targets, developing strong corporate finance capabilities, and improving governance and risk management will help ensure the next downturn is not quite so painful.

Endnotes

¹ This number excludes investments in real estate projects, companies in which they have less than 20 percent ownership, and investment in funds.

About the Authors

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