



## THE RISE OF VENTURE CAPITAL IN THE MIDDLE EAST

**SHAHRAM SAFAI**, PARTNER AT LAW FIRM AFRIDI & ANGELL, EXPLORES THE RISE OF VENTURE CAPITAL IN THE REGION, AND WHAT STEPS YOU NEED TO TAKE TO ENSURE ANY INVESTMENT DEALS ARE LEGALLY SOUND.

**D**ubai has become the undisputed entrepreneurial capital of the Middle East due to its soft and physical infrastructure and its openness to business. It attracts investors, world-class advisors and, of course, entrepreneurs. The entrepreneurs can be MBAs, bankers, computer professionals, engineers, health professionals and many others.

But, where is a starting entrepreneur to find money? Banks are strict and require a proven business plan, a track record, revenues and audited financials, which many entrepreneurs do not have. Traditional investors in the region focus on a 51:49 investment mentality which is more likely to become a lose-lose proposition for a start-up entrepreneur.

In such situations, most commonly, an entrepreneur's choice will be between raising the funds from family and friends and obtaining venture capital financing. Family and friends may be willing to invest at a lower price (i.e., to accept a higher valuation of the company at the time they invest) but often bring little else to the table.

Venture capitalists may demand a lower valuation but will almost always bring many intangibles that can assist the company to grow faster and to be more successful. They request a business plan but not audited financials, or a track record.

Venture capital financing can be an attractive funding source for other reasons as well. Venture capital may allow the entrepre-

neur to raise all of the capital from one source, or from a lead investor who can attract other venture funds. Venture capitalists have experience with the challenges of start-ups and know how to grow a company to an initial public offering, sale of the business, or other liquidity event.

Experienced venture capitalists have a large network of contacts who can help the company succeed. Venture capitalists are often able to provide valuable assistance in recruiting other members of the management team.

Also, being venture-backed gives an enterprise a certain cachet, which can open doors to other financing and resources.

Venture capitalists have focused on the information-technology



industry, which includes computer hardware and software, scientific instruments, telecommunications, multimedia, and, cyberspace. Examples include Yahoo!, and Apple Computer. Venture capital investing has also been in life science companies, including those focusing on biotechnology, medical devices, diagnostics, and therapeutics. Genentech and Amgen were both venture-backed. They have also invested successfully in retail, consumer products, new materials, health services, and environmental technology.

Venture capital financing has been on the rise in the Middle East and such rise is set to accelerate exponentially in Dubai in the next decade.

Venture capitalists normally request preferred shares in return for their investments. The rights and protections normally given venture capitalists buying preferred shares include the liquidation preference, the dividend preference, redemption rights, antidilution provisions, voting rights, right of first refusal, co-sale rights and vesting on Founders' shares. The following is a brief description of such rights which should be carefully negotiated and even more carefully drafted into a contract:

#### **Liquidation preference**

Upon liquidation of the company, the preferred share will receive a certain fixed amount before any assets are distributed to the common shares.

#### **Dividend preference**

Generally, a dividend must be paid to the preferred shares before any dividend is paid to the common shares. This dividend may be non-cumulative and discretionary, or it may be cumulative so that it accrues from year to year until paid in full.

#### **Redemption**

Preferred shares may be redeemable, either at the option of the Company or the investors or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the shares.



▲ Venture capitalists can often provide good contacts to help your business succeed.

## Venture capitalists have experience with the challenges of start-ups

#### **Anti-dilution protection**

The conversion price of the preferred shares into common shares (i.e. for an initial public offering) will be subject to adjustment for diluting events, such as share splits or share dividends, and will probably also be subject to "price protection," which is adjustment upon future sales of shares at prices below the conversion price.

#### **Voting rights**

On general matters, preferred shares usually votes along with common shares and have a number of votes equal to the number of shares of common shares into which it is convertible. The preferred shares also typically have special voting rights, such as the right to elect one or more of the company's directors or approval of certain types of corporate actions, such as amendments of the Memorandum, mergers or creation of a new series of preferred shares.

#### **Right of first refusal**

Holder of preferred shares generally will have a right to participate, usually at up to an investor's current aggregate ownership percentage, in any future issuance of securities by the company.

#### **Co-sale right**

Preferred investors often will require founders to agree to co-sale rights which provide some protection against founders selling their interest in the company to a third party by giving investors the right to sell a portion of their shares as part of any such sale.

#### **Vesting on founders' shares**

As a protection against founders leaving the company after the investment money is in, venture capitalists generally insist on some sort of "vesting" on founder's shares, so that a percentage of such shares, decreasing over time, is subject to repurchase by the company at cost if a founder terminates his or her employment.

Seeking investment from a venture capital fund or "angel" venture capital investor can provide much needed "smart" capital for an entrepreneur. However, the rights and protections must be negotiated and carefully legally drafted to obtain a balance between founder control and venture capital know how. 

► **Shahram Safai** practices venture capital law and represents venture capitalists, investors and entrepreneurs. Shahram is also a professional engineer and has previously worked in the Silicon Valley in California practicing venture capital law, mergers, and acquisitions. He is a partner at the law firm of Afridi & Angell.