

PANORAMIC

VENTURE CAPITAL

United Arab Emirates



 LEXOLOGY

Venture Capital

Contributing Editor

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MARKET AND PURPOSE

General role and purpose

How would you describe the role of venture capital in the financing markets in your jurisdiction?

Historically venture capital has not played a large role in financing markets in the United Arab Emirates (UAE); however, this is changing rapidly. Venture capital and venture capital funds are increasingly becoming an integral part of the UAE's corporate finance landscape. The importance of venture capital is expected to continue to grow in the coming years.

Law stated - 6 February 2024

Market conditions

How would you describe the current market conditions for venture capital in your jurisdiction?

The current market conditions in the UAE for venture capital are favourable, with the UAE witnessing a flurry of venture capital activity while deals dry up in other jurisdictions. This growth in venture capital funding can be attributed to growing technology adoption and the shift from high dependence on oil revenue, which is creating investment opportunities and attracting global venture capital firms to the region.

Furthermore, the UAE is actively encouraging foreign venture capital investment with changes in the onshore UAE law helping to facilitate venture capital, with the most important change being permission for foreign (non-UAE) nationals to acquire and own most types of companies incorporated 'onshore' in the UAE.

Measures have also recently been taken to actively assist the formation of investment funds (including venture capital funds) in the UAE. For example, there has been growing cooperation between the three relevant regulators in the UAE, being the Securities and Commodities Authority, the Dubai Financial Services Authority of the Dubai International Financial Centre, and the Financial Services Regulatory Authority of the Abu Dhabi Global Market in relation to the licensing and recognition of investment funds registered in any one of these three jurisdictions.

Law stated - 6 February 2024

PARTIES AND DEAL STRUCTURES

Issuers – typical profile

How would you describe the types of companies, and their different stages of development, that typically receive venture capital investment in your jurisdiction?

Venture capital funding in the UAE is generally made available to entrepreneurs and companies in the seed capital, start-up and growth phases.

It is common for venture capital funds in the UAE to be industry-specific, although there are a number of funds that have broad investment objectives. As with most jurisdictions, venture capital firms tend to invest heavily in companies in the technology-media-telecommunications (TMT) sector. However, given the reluctance by banks to provide financing to start-ups, venture capital is also sought by businesses in a number of other industries including food and beverage, retail, education and healthcare.

Law stated - 6 February 2024

Issuers – domicile and company structures

Are there any preferred or required legal domicile or company structures for issuers in venture capital transactions?

The UAE is not a unitary jurisdiction in so far as company formation or licensing is concerned. As such, there are numerous options available for issuers in venture capital transactions. However, the preferred vehicle is for an issuer to establish a special purpose vehicle incorporated in the Abu Dhabi Global Market (ADGM) and in certain instances, the Dubai International Financial Centre (DIFC). Such companies are limited in scope and are typically incorporated for the sole purpose of holding the relevant ownership interests of the entity (or entities) comprising the underlying business.

Law stated - 6 February 2024

Investors – typical profile

How would you describe the types of investors that make venture capital investments, including by stage of company development, in your jurisdiction?

Venture capital investors in the UAE can be individuals, companies, investment or sovereign wealth funds. In the UAE there is a particular prevalence of sovereign wealth fund investments that fund a range of different local and regional start-ups, typically in industries of strategic interest.

Venture capital fund subscribers include: High net-worth individuals, local family offices, sovereign wealth funds, or public sector investment funds (including pension funds). The UAE has recently implemented substantial reforms in the regime applicable for end of service employment benefits for foreign nationals, permitting the creation of government administered saving schemes. It is widely anticipated that this change will have a further impact on the flow of funds into venture capital investments.

Law stated - 6 February 2024

Investors – structures

How are venture capital investors usually structured and does their structure affect their investment approach or terms?

Venture capital funds can be established onshore in the UAE, as well as in the DIFC and the ADGM. Investment funds registered 'onshore' (and regulated by the Securities and Commodities Authority (the SCA)) have historically been uncommon; however, on 16 January 2023 the SCA substantially updated its investment funds regime. The new regime looks to encourage the establishment of investment funds onshore in the UAE and to encourage asset management activities to be localised in the UAE and has also substantially reduced the financial and administrative requirements applicable. This includes: (1) a reduction in minimum share capital requirements for fund management companies; and (2) removal of ownership restrictions previously remaining in place for such entities. The SCA has also committed to expedite review times.

In the DIFC, there are three types legal forms available for the establishment of an investment fund:

- investment companies;
- investment trusts; and
- investment partnerships.

Similar structures are available in the ADGM. While trust structures are predominantly used for property funds, investment partnerships are more commonly used for private equity and venture capital funds. Venture capital funds established as offshore limited partnerships and exempted companies are commonly used to invest in UAE companies.

Law stated - 6 February 2024

Seed financings

What structures and types of investments are typically used for seed-stage investments in your jurisdiction?

Depending on the nature of the investment (ie, whether it is intended as debt or equity) it is typically the case that a seed-stage investment will either be undertaken using:

- a convertible note (or even a simple loan note); or
- a simple agreement for future equity.

Given the nature of a seed-stage investment, the instruments used are typically intended to be relatively simple to avoid the need for extended negotiations and to limit the costs incurred to negotiate and finalise the investment documentation.

Law stated - 6 February 2024

Early-stage and later investments

What structures and types of investments are typically used for early-stage and later investments, following seed-stage investments, in your jurisdiction?

Follow-on investments after the seed-stage will typically be undertaken as a priced subscription for equity. A venture capital investor will typically subscribe for shares in the issuer and will enter into one or more transaction documents that will typically consist of a share subscription agreement or a shareholders' agreement, and may be supplemented by other ancillary agreements such as an investment agreement.

Law stated - 6 February 2024

PROCESS

Term sheets

Do parties normally use term sheets? If so, what is normally covered in such term sheets?

or a 'letter of intent'). This is typically entered into between the company's founders and the venture capital investors, and is drafted to outline the principal terms of the transaction. A term sheet will typically cover:

- a preliminary valuation and investment amount;
- liquidation preferences;
- anti-dilution provisions;
- information on the board of directors;
- dividends;
- voting rights; and
- rights concerning any exit from the investment.

Law stated - 6 February 2024

Documentation

What are the standard documents for a venture capital transaction, and who prepares them? Are there popular forms for such documentation in your jurisdiction?

At present there are no standardised investment documents available (or commonly used) specifically for the UAE market. Investors will, however, look to use international standard documents (for example, those issued by the British Private Equity & Venture Capital Association in the UK) as a starting point and then tailor them to comply with any particularities of the UAE and to the transaction.

The principal legal documents used in a venture capital investment in the UAE are the term sheet, share subscription agreement, and shareholders' agreement, and may also include (or are supplemented by) an investor rights agreement, voting agreement and right of first refusal and co-sale agreement. A venture capital investor may also require the target company and its founders to sign a non-disclosure agreement and procure one or more legal opinion from the target's lawyers.

Law stated - 6 February 2024

Key steps and timing

What is the normal process and timing of venture capital investments in your jurisdiction?

Typically, discussions between an issuer and a venture capital investor will commence with the signing of a non-disclosure or confidentiality agreement and a preliminary term sheet or letter of intent. The key steps and timing will depend on the size and stage of the investment. For small investments, the parties may either negotiate investment documentation in parallel or may even choose to skip preliminary documentation and proceed directly to discussion on transaction documentation (this would be particularly relevant in seed-stage or even early-stage investments where timing and costs are points of sensitivity). For more complex or later stage investments, parties will typically devote some time to ensuring that broad parameters are agreed (typically in the form of a term sheet or letter of intent) prior to expending resources on full-form investment documentation.

Law stated - 6 February 2024

Closing conditions

What closing conditions are common in venture capital transactions?

The most common closing condition included in venture capital transactions in the UAE is for the investors to seek representation on the target company's board of directors. Venture capital investors in the UAE typically prefer to take an active role in the management of early-stage companies, therefore having representation on the board is important. However, if the investor does not have board representation, it is likely to be entitled to consult with and advise the company's management team on significant business issues (such as proposed annual operating plans and budgets).

In addition, given the particular structuring considerations that are relevant for the UAE, a venture capital investor may require that an issuer first complete a restructuring to ensure that the issuer has a legal form and structure that is suitable for venture capital investment. This may, for example, include the establishment of a holding structure with a special purpose vehicle incorporated in the Abu Dhabi Global Market.

Law stated - 6 February 2024

Multiple closings

Are venture capital transactions ever divided into multiple closings? If so, how and why?

Multiple closings may be relevant in venture capital transactions that envisage multiple investors completing at different stages. It may be the case that an issuer agrees the terms of investment with a single investor or a core group of anchor investors and then expands the investment round to other investors on the condition that such follow-on investors accept

the original terms agreed with the anchor investors. In such a situation, a venture capital transaction could indeed be divided into multiple closings.

Law stated - 6 February 2024

DUE DILIGENCE

Legal due diligence

What legal due diligence is typically undertaken for venture capital transactions, and what specialists are typically involved?

Legal due diligence in the context of a venture capital transaction will frequently depend on the stage of investment. For example, in the context of seed-stage investments, a venture capital investor will typically focus on confirming matters such as:

- due incorporation and existence;
- corporate good standing;
- ownership or control of intellectual property;
- arrangements between the issuer and the founder(s);
- absence of material litigation; or
- the existence of debt or other capital commitments.

For later stage investments, due diligence will typically encompass a broader range of issues.

A legal due diligence exercise in a typical venture capital transaction will include a core corporate team along with support from the following specialists:

- commercial/information technology;
- intellectual property;
- dispute resolution; and
- financing and banking.

Depending on the nature of the business of the issuer, specialists with expertise in financial regulation may also be involved.

In each case, speed is typically a point of sensitivity for issuers, in particular where discussions with multiple investors are taking place.

Law stated - 6 February 2024

Critical due diligence areas

What are normally critical areas of due diligence focus or red flags in venture capital transactions?

Venture capital funds typically perform thorough financial and legal due diligence to evaluate a potential investment opportunity. The diligence review is intended to identify and mitigate the key risks associated with the investment.

The initial due diligence is intended to screen business opportunities given the life of the fund and uses predetermined criteria to identify which opportunities to focus on as possible investments. The screening process typically eliminates opportunities that do not fit the fund's mandate or investment objectives. In addition, some venture capital investors only review opportunities that have been referred from a trusted source or involve an entrepreneur that has had previous success.

Once an opportunity clears the screening process, a venture capital investor will typically investigate the potential issuer to determine whether the deal is viable. An investor will typically review the following:

- management team;
- market potential;
- product or service;
- business model; and
- financial projections.

Some investors also produce their own financial models to evaluate the potential investment.

Following the financial due diligence, the investor typically arranges for a legal due diligence review of the investee company, which (among other things) ensures that the proposed investment structure is viable. Some venture capital investors will undertake due diligence using internal resources (particularly for small investments) but many will at this stage retain outside counsel.

Law stated - 6 February 2024

Other due diligence

What other types of due diligence are commonly undertaken in venture capital transactions?

This varies on the nature of the underlying business; however, an investor may undertake detailed commercial (separate from financial) diligence to ascertain whether the projections and assumptions underlying the investment are sound. Where relevant, an investor may undertake in-person site visits to inspect any facilities (for example, manufacturing facilities where relevant) or premises that they consider material to the business.

Law stated - 6 February 2024

ECONOMIC TERMS

Valuation and pricing

How is the company valuation and investors' purchase price usually determined in venture capital transactions?

Valuation of companies for venture capital financing is inherently difficult given the lack of available information and operating history, and early-stage ventures have difficulty obtaining bank financing in the UAE for this reason. Accordingly, venture capital funds typically have industry professionals who are skilled at making long-term projections and evaluating the company's business plan. The venture capital fund may also develop its own forecast of the investee company's financials (rather than relying on that company's own forecast), which will be based on comparable enterprises, industry standard ratios and exit valuations.

The valuation of the investee company will necessarily change as it procures additional financing. For each round of financing, the angel investors and venture capitalists conduct pre-money valuations to determine the amount of equity to acquire in exchange for the proposed funding for the entrepreneur or start-up, which in turn determines the company's post-money valuation.

The pre-money valuation is carried out based on the price per share that the investors are offering to pay the start-up company multiplied by the total number of shares outstanding (including options, other convertible securities and shares reserved for employee stock options).

Pricing of the investment round is done on a fully diluted basis, meaning that the investor takes into account the current (and, in some cases, proposed) securities that are convertible into common stock (for example, options and warrants).

The frequently adopted position for seed-stage or early-stage ventures is to determine valuation by contrasting the company's position in the future with the desired rate of return by the investors for the near future. However, in practice, venture capital investors tend to estimate the amount of cash required to achieve some development milestone and equate that amount to a certain percentage of the company. It is often the case that a seed-stage or early-stage venture in the UAE is likely to be valued on a similar scale at what valuations venture capitalists have been giving to other companies with a similar business model. Valuations may also be driven (at least in part) to the valuation assigned in a prior funding round.

Valuations are typically made in UAE dirhams or US dollars, although foreign investors occasionally prepare their valuations in the currency of their country of origin.

Law stated - 6 February 2024

Option pool

What do investors typically require for option pools or equity incentive arrangements in connection with venture capital transactions?

Management incentives are commonly granted through the issue of shares or participation in the issuer's profits, and employee share option schemes may also be implemented. In particular, an investor can stagger the vesting of a founder's shares (typically, over a four-year period with a one-year cliff) to encourage the founder to continue his or her employment with the company.

Law stated - 6 February 2024

Dividends, distributions and redemptions

What are the normal provisions governing dividends, distributions, redemptions or other profit distributions in venture capital transactions?
Are there any legal limits thereon in your jurisdiction?

Venture capital investors commonly request convertible preferred shares in return for their investments. The rights and protections usually associated with these shares include a dividend preference that entitles the holder to a dividend (which may be non-cumulative and discretionary or cumulative) before any dividend being paid to the common shareholders is a provision that is typically included in the documentation.

Law stated - 6 February 2024

Company sales and liquidations

How are venture capital investments treated in portfolio company sales or liquidations?

Venture capital investors commonly request convertible preferred shares in return for investment. The rights and protections usually associated with these shares include a liquidation preference that entitles the preferred shareholder to receive a certain fixed amount (expressed as a multiple of the shareholder's original purchase price, plus any declared and unpaid dividends) before any assets are distributed to the common shareholders in a liquidation.

Law stated - 6 February 2024

Anti-dilution protection

What anti-dilution protections are typically built into the terms of venture capital securities?

Venture capital investors commonly request convertible preferred shares in return for their investments. The rights and protections usually associated with these shares include anti-dilution rights that protect an investor from dilution resulting from subsequent share issuances at a lower price than the investor originally paid by adjusting the conversion price applicable to the investor's preferred shares.

Law stated - 6 February 2024

Future investments

What pre-emptive or pro rata investment rights do venture capital investors usually receive?

Venture capital investors commonly request convertible preferred shares in return for their investments. The rights and protections usually associated with these shares include a pre-emption right that enables the preferred shareholders to participate in any future issuance of securities by the company (up to its percentage shareholding as of the date of the issuance).

Law stated - 6 February 2024

Insider sales

What rights do venture capital investors normally have over insider sales of securities of portfolio companies?

Venture capital investors will typically negotiate suitable restrictions on insider sales of securities of portfolio companies and will typically expect that key management personnel refrain from sales of securities during the term of the investment.

Law stated - 6 February 2024

CONTROL RIGHTS

Voting rights

What voting rights, including veto or consent rights, do venture capital investors normally have as shareholders of their portfolio companies? Do they typically have special voting or consent rights as shareholders?

Venture capital investors commonly request convertible preferred shares in return for their investments. The rights and protections usually associated with these shares include voting rights that generally allow the preferred shareholders to:

- vote with common shareholders (as though the shares had been fully converted);
- elect one or more of the company's directors; and
- approve certain types of corporate actions (for example, amendments to constitutional documents, proposed mergers, and issuance of a new series of preferred shares).

Law stated - 6 February 2024

Board rights

What rights to representation on the board of directors or at meetings of the board of directors of portfolio companies do venture capital investors typically receive?

Venture capital investors in the UAE typically seek representation on the issuer's board of directors. Venture capitalists in the UAE prefer to take an active role in the management of early-stage companies, therefore having representation on the board is important. However,

if the fund does not have board representation, it is likely to be entitled to consult with and advise the company's management team on significant business issues (such as proposed annual operating plans and budgets).

Law stated - 6 February 2024

Board protections

What fiduciary duties and liability protections normally apply to investor directors in your jurisdiction? Do directors typically have special voting or consent rights?

The UAE is not a unitary jurisdiction for the purposes of company incorporation and licensing. Accordingly, the duties and liability protections that are available to an investor director depend on the jurisdiction within the UAE that the issuer is established.

Typically, an investor director will be required to act in the best interests of the body corporate and may be subject to restrictions of confidentiality with regard to sensitive company matters. Depending on the size and nature of the venture capital investment, investors may be able to negotiate special voting or consent rights concerning very material decisions; however, this is typically seen in late-stage investments rather than in seed-stage or early-stage investments.

Law stated - 6 February 2024

Financial reports

What rights to financial reporting or company access do venture capital investors normally receive?

Investors typically have inspection and information rights. Specifically, the shareholder can examine the books and records of the company and inspect its facilities, and the company will be required to provide the shareholder with periodic financial reports.

Law stated - 6 February 2024

PUBLIC OFFERINGS AND LISTINGS

Securities law requirements

What are the securities law requirements in your jurisdiction for venture capital investors to sell their securities in the public markets?

To market, promote or sell securities of any description in the UAE public markets, venture capital investors will typically be required to satisfy the requirements imposed by the Securities and Commodities Authority (and in addition, may be required to comply with requirements imposed by the Dubai Financial Services Authority or the Financial Services Regulatory Authority, depending on the intended purchasers of such securities). The particular requirements imposed will depend on the nature of the securities being sold and the intended purchasers, but will typically include disclosure, transparency and ongoing

reporting in connection with any securities being sold and the issuer of those securities. In certain instances, a prospectus may also be required.

Law stated - 6 February 2024

Registration and listing rights

What registration rights, listing rights or other rights do venture capital investors normally receive?

Given the relatively limited role of the public markets in venture capital transactions in the UAE, there is no standard suite of registration, listing or other similar rights that are included for venture capital investors. Typically, venture capital investors will look to agree basic provisions and parameters of an exit from the investment.

Law stated - 6 February 2024

Other resale rights

What other resale rights in the public markets do venture capital investors usually receive?

As yet the public markets have not been used in the context of venture capital exits and as such, market standard on this has not yet developed.

Law stated - 6 February 2024

COMPANY SALES (M&A)

Standard sale structures

What are the standard structures or methods for venture capital portfolio companies to be sold in your jurisdiction?

Typically, venture capital portfolio companies will be sold through a trade sale or a secondary buyout by another venture capital or private equity investor. While there are no standard structures used for such transactions, as noted the use of Abu Dhabi Global Market special purpose vehicles is very common.

Law stated - 6 February 2024

Role of investors

**What is the role of venture capital investors in a portfolio company sale?
Do they have rights to force or block a company sale?**

It is common for a venture capital investor to invoke a put option in the event of an unsuccessful investment. In these cases, the investor has the right to have its shares purchased at a predetermined exercise price (which often includes a premium over the

acquisition price) by the company if certain financial thresholds concerning the company's revenue or net profits have not been met.

Many venture capital funds negotiate a right to force the sale of the company after a certain period, in which case the founders (or any other shareholders) have no right to vote on the exit transaction. This right enables the investor to wind up its investment in accordance with the fund's investment term. However, a forced sale is unlikely to yield the maximum value for the company, and subsequent investors are unlikely to agree to such a restriction, which will hinder the company's ability to secure future financing. It may also be feasible for an investor to compel an exit above a certain valuation or on achieving a minimum threshold of returns for preferred shareholders.

The most likely liquidity events for successful companies in the UAE are in the form of trade sales and secondary buyouts. While some investors have exited venture capital investments by way of an initial public offering, this is still very uncommon.

Law stated - 6 February 2024

Post-closing protections

What post-closing matters or protections do venture capital investors typically obtain, for example to address ongoing company sale indemnities or director tail liabilities?

Post-closing protection will typically be heavily context specific and will be requested to address specific known risks and issues identified in the course of due diligence.

Law stated - 6 February 2024

LEGAL AND REGULATORY CONSIDERATIONS

Disputes

What types of disputes typically arise in venture capital transactions and how are disputes commonly handled? What provisions normally govern disputes, including choice of governing law, choice of forum and alternative dispute resolution mechanisms?

Most venture capital disputes will arise due to one or more of the following:

- inaccurate or incorrect post-closing reporting from the issuer's management team;
- inaccurate accounting or financial record-keeping;
- breach of warranty provided in investment documentation.

Venture capital investment documentation in the UAE will typically be governed by the law applicable in the Dubai International Financial Centre (DIFC); the Abu Dhabi Global Market (ADGM); or a foreign (non-UAE) jurisdiction of choice, with jurisdiction for dispute resolution also resting with either the DIFC or the ADGM courts. While arbitration is common in the UAE, its utility in the context of a venture capital transaction needs to be considered in context due to the substantial expense and protracted process involved.

Law stated - 6 February 2024

Regulatory consents and filings

What regulatory consents, notifications and filings are required for all investors in venture capital transactions in your jurisdiction? Are there ownership restrictions?

The consents and filings required in a venture capital transaction will depend on the jurisdiction within the UAE in which the issuer is established and the industry in which it operates. For example, if the issuer operates in the financial services sector, regulatory consents or notifications may be required to be filed with the relevant financial services regulator (this may be the UAE Central Bank, the Securities and Commodities Authority, the Dubai Financial Services Authority or the Financial Services Regulatory Authority).

The UAE has a comprehensive competition (including merger control) regime that regulates and encourages healthy competition in the UAE markets and has a stated focus on consumer protection. The applicability of the UAE competition regime will need to be considered in context depending the industry, size and scale of the issuer and its underlying business.

Law stated - 6 February 2024

Foreign investment

What foreign investment restrictions and other domestic regulatory issues arise for venture capital investors based outside your jurisdiction?

For issuers that are incorporated 'onshore' in the United Arab Emirates, there may be residual foreign ownership restrictions that apply for certain specific industries and sectors (for example, for certain financial services businesses, in insurance, or in the oil and gas sector) and where these industry-specific restrictions apply they will require to be considered by venture capital investors.

Law stated - 6 February 2024

UPDATE AND TRENDS

Key developments

What are the most noteworthy current trends and recent developments in venture capital transactions in your jurisdiction? What developments are expected in the coming year?

There has been an increase in venture capital activity in the UAE in recent years, particularly in the Emirates of Abu Dhabi and Dubai as they both commonly serve as regional hubs for expansion into other countries in the Middle East, North Africa and South Asia, as well as a launch pad for inbound investments into the UAE. While investors are still taking a measured approach (and in many cases providing funding only to more proven

growth-stage companies), venture capital firms are more readily providing seed capital financing and commercial assistance (including incubator services) for entrepreneurs and start-up companies.

Government entities have also ramped up their efforts to assist early-stage ventures. A number of UAE free zones (in particular the Dubai Silicon Oasis and the Dubai International Financial Centre (DIFC) in the Emirate of Dubai, and the Abu Dhabi Global Market (ADGM) and twofour54 in the Emirate of Abu Dhabi) provide seed funding, training and/or strategic advice for entrepreneurs in the TMT sector. The government of Dubai has also launched the Dubai Future Accelerators programme, aiming to encourage young entrepreneurs to address the challenges facing the current age.

Similarly, the DIFC has introduced the FinTech Accelerator Programme, aimed at providing startups access to leading accelerator programmes, mentorship from leading financial institutions and insurance partners, along with a dedicated space to work alongside a community of like-minded individuals.

In the Emirate of Abu Dhabi, the ADGM has introduced a licensing regime specifically catered towards tech startups that allows entrepreneurs to obtain an operational licence in the ADGM and access to a Professional Services Support Programme aimed at allowing entrepreneurs entry to a community of businesses, financial services and professional advisers. As the availability of funds for start-ups improves, there will be more opportunities for venture capitalists to invest in more mature businesses.

Law stated - 6 February 2024