

Family Business Shareholder Exit Strategies and Valuation Principles

Successfully navigating an exit:
what family businesses need to be
aware of



Preamble

April 2019

- *Family businesses have always been an engine for growth and their success translates into prosperity for their respective region.*
- *As Middle East family businesses transfer control to the second and third generations, a number of challenges arise, and the need to set a robust governance framework aligning the growing number of shareholders becomes paramount.*
- *A critical scenario that needs to be carefully managed is when a shareholder decides to exit the family business and sell his equity stake.*
- *Proactively managing that process is essential for assuring long-term family business continuity, harmonious family relations, and shareholder ownership responsibility.*
- *This report, jointly developed by PwC and Family Business Council - Gulf (FBCG), aims to raise awareness and guide family businesses on various aspects of managing the exit process, including exit scenarios, valuation considerations, and the legal frameworks to consider*





The unique dynamics of family-owned businesses become particularly apparent in the case of a family member deciding to leave the business. Whether this step is to be taken by business owners themselves or other stakeholders, the decision triggers a process which requires meticulous planning and open dialogue. The goal is to achieve a balancing act between preserving personal freedom and financial security of family members and ensuring that the future of the business remains intact.

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Navigating a shareholder exit process

Family business shareholder exits can be accompanied by a great degree of complexity as there are many options and related considerations. This report aims to serve as a roadmap to help family business shareholders identify opportunities and challenges related to an exit process.

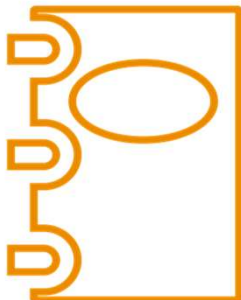
Objectives of this report:

- **Address motivations and key considerations** in the case of an exit for a fair and optimized outcome
- **Outline** main business **valuation criteria**
- **Define exit routes** that are suitable depending on the exiting shareholder's motivation
- **Describe the legal framework** for exits
- **Address** high level **tax considerations** during exits
- And ultimately, **raise awareness** on the importance of being prepared by setting good governance well before an exit scenario arises

In particular, ensuring preparedness by setting commonly agreed guidelines amongst shareholders in advance makes a great impact on the development of the exit process. As the results of our last two biennial PwC Family Business Surveys indicate, despite being aware of the challenges and sensitivities involved, many businesses do not have adequate plans in place.

Only **31%** of businesses have a robust, documented and communicated succession plan in place, with only 12% making it to the 3rd generation

Source: PwC research



Less than **33%** of large family businesses in the GCC region have effective policies and practices in place to govern the family business. Families lack policies addressing challenging family dynamics and common conflict areas.

Source: FBCG research

Anticipate, prepare, act

Family businesses constitute some of the oldest and most successful companies in the world. PwC's experience of working with family businesses suggests that those that have endured have put in place robust legal structures and governance mechanisms aimed at ensuring growth and continuity of the family business.

However, growth and continuity can only be achieved if succeeding generations of owners continue to grow and expand the business. Family businesses need to continuously grow every year if future generations are to enjoy the same levels of wealth as the previous generations. Achieving growth of this magnitude requires a high degree of trust, transparency, communication as well as alignment between the various stakeholders in a family business i.e. shareholders, family members and the Board / Management.

The reality of course is that family businesses are seldom perfectly aligned and perceptions of unfair treatment and a lack of transparency in decision-making are abundant. Such circumstances can inevitably lead to family members choosing to exit.

That said, there are also several examples of Middle Eastern family businesses that have been driven by pure commercial considerations in choosing to divest a part of their shareholding, as part of a wider strategy to grow and expand the business. In circumstances such as these, planning for and being aware of the various options, i.e. IPO of a part or the whole business, trade sale, private equity participation, etc., as well as understanding the implications has to be a key factor in the planning and decision-making process.

The key to successfully navigate through change is proactive planning. Agreeing in times of peace when there is objectivity on the business' long-term vision enables a smooth transition process in the future. Defining family protocols and having a clear overview of legal and tax implications stemming from an exit, as well as being aware of potential exit routes helps the family identify what works best for the business.



Issues leading to an exit from a family-owned business

An exit can occur following a personal decision by a shareholder who wishes to continue on a different path or stem from a business decision to increase the company value by bringing in external investors and capabilities. Some of the reasons are outlined below.

Family considerations:

- Perceived unfairness between active and passive family members
- Family conflict
- Issues around family members working in the business
- Choosing future leaders of the family and business (succession considerations)
- Liquidation of assets / cash-out decision for departing shareholder
- Shareholder seeking personal or professional fulfillment outside of the family business



Business considerations:

- Stakeholder disagreement / misalignment on ownership structure and future strategy of the business
- Business decision to change company course, i.e. selling or listing the company
- Deciding between reinvestment of profits and payment of dividends
- Poor business performance and lack of transparency



Key questions arising during a family member's exit

- What are the agreed mechanisms that regulate the exit procedure?
- How can the interests of both the departing family member and the company be protected?
- How can the shares of the departing family member be fairly valued?
- What is the impact on the business, the departing shareholder, and the family?
- Will the departing family member retain any involvement in the company?
- How should the exit be structured in order to maximize value for the company in the case of a sale to a third party?
- In the case of a departing majority shareholder, should the business continue in its current form, be sold to a third party or be publicly listed?
- How should the exit be structured and timed in order to maximise value and mitigate taxes and other costs for both parties involved in the transaction?

Families in the Middle East region often discourage shareholders from exiting the business due to the emotional and financial distress that often results from such a decision.

However, if a shareholder is determined to leave the business, the exit process needs to be regulated with pragmatic professionalism to maintain the company integrity and the family relationships. In a time that is critical for the business there is no room for family feuds. For this purpose, ***the ideal scenario calls for documented protocols which have been agreed and formalised well in advance and describe the exact process to be followed by all involved parties.***

The common thread for all exit scenarios: They all call for a valuation of the business in order to be able to assess the current company worth as well as the projected future value in order to identify a fair price for the departing family member's shareholding.



“It’s not personal,
it’s business”

Valuation is an art, not a science

Value is high on the agenda of any business. Decisions relating not only to shareholder exits, but also to strategic direction, group restructuring, mergers and acquisitions, disposals of businesses, raising debt, tax planning or leveraging intellectual property lead to questions on a business's value.

Valuation, by its very nature, is subject to the exercise of individual judgment. Key factors influencing valuation are the circumstances of the transaction (e.g. valuation in a competitive vs. non-competitive bidding environment), the nature of the business (e.g. the incoming shareholder's perception of potential synergies), the negotiating ability, the buyer's motivation.

While valuation is not an exact science, there are certain standard approaches that can be used to determine the value of a business. **Fair value** is defined under the International Financial Reporting Standards as *"the price that would be received to sell a business in an orderly transaction between market participants at the measurement date"*, i.e. a price that a willing buyer and a willing seller, neither of whom is under any compulsion to buy or sell, would be willing to transact at.

Some of the key methodologies which are usually adopted to determine the fair market value of a business are the following:

- **the income approach:** determining the value based on the future profitability / cash flows that the business can generate
- **the market approach:** determining how are similar businesses valued in the market, based on an analysis of comparable public companies and similar transactions

Other approaches such as the **net asset approach** (determining the current net book value of the assets) and the **cost approach** (determining the cost to re-setup the business in its current state) can also be used but are less common. The deciding factors on which method to use are often the nature of the business being valued, the sector in which the business operates, as well as the purpose, price point and/or the duration of the valuation.



Factors influencing a valuation

For the valuation a series of business performance factors is considered – in the case of family businesses there are additional considerations which impact the valuation outcome. This is especially relevant in the case of a sale to a third party.

Family business considerations:

- **Key-Person Risk** – Is an influential shareholder planning to depart?
- **Decision-making process and shareholder alignment** – How are value-defining business aspects such as operations and investments impacted by decision-making?
- **Governance framework** – Are there transparent mechanisms and regulating protocols in place?
- **Goal congruence amongst key stakeholders** – Are the interests of shareholders and management team aligned?
- **Well-performing vs. underperforming parts of the business** – In the case of conglomerates, are parts of the business kept in the portfolio due to historic or sentimental reasons despite being under-performing?
- **Majority vs. minority stake** – Are the interests of an incoming external shareholder and the family aligned?



General business considerations:

- **Nature and history of the business** – What has been the historic growth of the business?
- **Future outlook of the business's sector** – What are the growth prospects and the key risks of the industry the business is operating in?
- **Revenue generating capacity and dividend paying ability** – What are the forecasted profitability of the business and dividend policy?
- **Level of diversification** – Are there increased risks or benefits due to investment in a single sector?



Valuation discounts and premia

While the market value of a publicly traded company can be easily and transparently determined at any given time, for privately held businesses a discount (or premium) can be applied to determine the value of the business.

Valuation discounts / premia for family businesses depend on a number of factors and are not easily quantifiable. An example of a high range for a discount (25-30%*) would be the case of a minority shareholder of a privately held family business deciding to sell his/her stake to an external third party. However, for transactions between the shareholders of a family business, shareholders may agree a protocol (through a formal shareholders' agreement) to value the business using certain agreed valuation principles, including application of discounts / premia, in the case of separation or future buyouts within the family members.

Key factors determining a valuation discount:

- Lack of marketability and liquidity due to low profitability, limited potential for growth, and high volatility in the underlying sector
- Lack of control for a potential incoming shareholder (e.g. in the case of exit from a minority stake) or significant minority protection rights of minority shareholders
- Insufficient goal alignment with majority shareholders and/or management
- Key-person discount in the case of an important shareholder opting to leave the business
- Ineffective or inexperienced management team and/or lack of governance
- Lack of reliable financial information



In cases where the buyer / incoming shareholder sees compelling reasons to invest in a company, a premium can be applied based on the review of similar transactions that were conducted.

Key factors warranting a valuation premium:

- Consistently profitable performance and significant growth opportunity for the family business, making it a valuable market opportunity
- Good goal congruence of the business and the incoming shareholder
- Synergistic benefits anticipated by a strategic acquirer in the case of merging with an existing business (e.g. enabling expansion into a new customer base)
- Control of the board and management, control of all decision-making and strategy, as well as direct access to cash flows
- A unique selling point that provides a competitive advantage
- High barriers to entry which aim to keep external investors at bay
- High effective control of the incoming shareholder providing low protection rights for minority shareholders



** Such a discount will typically be a combination of the discount for lack of marketability and the discount for lack of control of a minority stake in a privately held family business.*

Potential exit routes

The choice of exit route depends on the motivation behind the exit decision and each has different advantages and disadvantages. The most common exit route entails a particular shareholder wishing to leave the business.

Exit route	Advantages	Considerations
Private sale to an existing shareholder	<ul style="list-style-type: none"> • Business is kept in the family • Less disruptive option as there is a higher degree in alignment – business can run as usual 	<ul style="list-style-type: none"> • Seller may not get the best value for his or her shares • A more prominent family discount may be applicable
Initial public offering (IPO)	<ul style="list-style-type: none"> • Business obtains external capital for future growth • Shareholders have flexibility on the percentage of exit with opportunity to exit a larger stake in the future 	<ul style="list-style-type: none"> • Significant preparation and documentation is necessary to meet the requirements of the stock exchange regulator and the relevant authorities • A high degree of corporate governance is required • There is an emphasis on short-term profit goals to meet market expectations
Private sale to a strategic investor / trade sale	<ul style="list-style-type: none"> • A transaction of this type is driven by identified synergies and value creation opportunities such as portfolio diversification, market expansion, operational collaboration, building economies of scale. This can result into higher chances for a valuation premium. • Strategic investors typically have a longer investment horizon 	<ul style="list-style-type: none"> • Strategic investors typically seek to have a controlling stake • Strategic investors typically seek heavy involvement in management and operations and if they obtain a controlling stake they may replace or modify the existing management
Management buy-out (existing management acquires shares from family shareholders)	<ul style="list-style-type: none"> • This is typically a mutual decision that provides stability and is less disruptive • The business is well-known to its new shareholders 	<ul style="list-style-type: none"> • The family character of the business may be diluted
Private sale to a financial investor (sale to a financial institution or private equity firm)	<ul style="list-style-type: none"> • An exit of this type brings new skills, new funds, new networks to target high returns • The existing management typically continues with the company for a determined lock-up period 	<ul style="list-style-type: none"> • Financial investors are returns driven and the company undergoes a rigorous restructuring in order to make profit • The investment horizon is shorter than in the case of strategic investors • The family business is making a non-sentimental decision in this case

Conglomerate spin-offs and carve-outs

Many of the family businesses in the Middle East are conglomerates with multiple divisions. Shareholders may wish to exit certain non-core divisions but not others, where there may not necessarily be separation implications from a legal structure perspective. Such cases would require a restructuring exercise (e.g. spin-offs / carve-outs) in order to create a shareholding structure suitable for a transaction. Such cases vary in degree of complexity, and typically require lengthier preparation periods.

Transparency and information sharing are key

The level of information disclosure is an important consideration in any transaction process. During the valuation process the business is exposed so that family businesses may be reluctant to share certain information on the business especially to investors which may have competing businesses. This is a sensitive matter which needs due attention and disclosure of the appropriate level of information at the right time throughout the process, making process management a key consideration in transactions involving family businesses. The success of the transaction depends on the level of willingness to share information and lack of transparency may result in not achieving the desired price for the exiting shares.

Economic value vs. emotional value

While the economic value of a family business is attributed to its intrinsic value (based on the aforementioned valuation methodologies and adjustments), what is particularly relevant from a family business perspective is the emotional value that shareholders ascribe to it (such as an owner's attachment to a business his ancestors might have set up 50 years ago). Emotional factors could have both a positive and negative impact when determining a transaction value, e.g. family disputes / conflicts and dissent over another family member's involvement in the business might tempt one of the shareholders to sell their stake at price lower than what another shareholder might be prepared sell it for.



The legal framework for exits

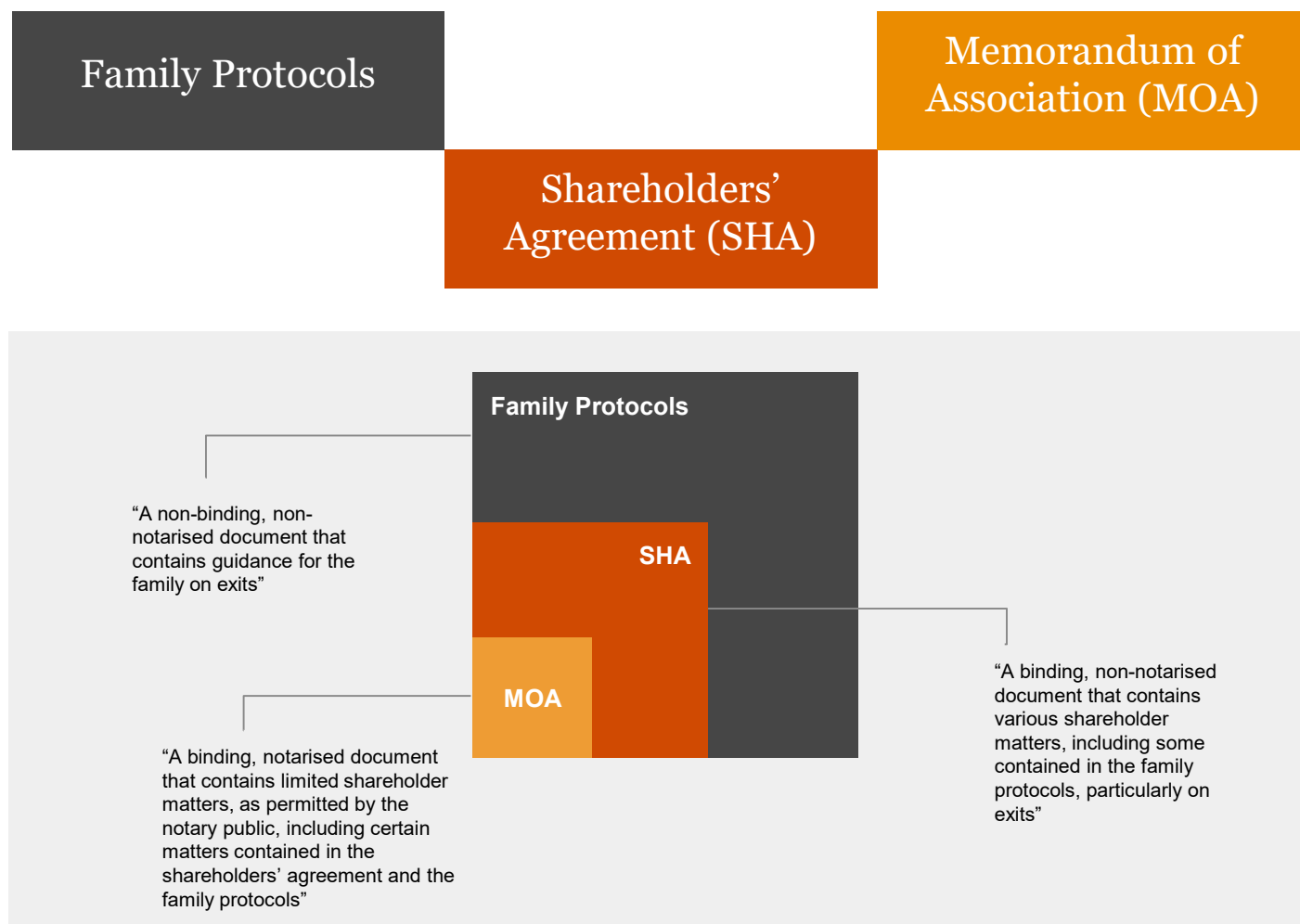
Family protocols, also known as the family constitution, usually contain the guidance and framework for the transfer of shares and exits. The family protocols are non-binding and relate to the family at large.

The process of an exit is governed by law. Generally, the law requires that a selling shareholder must offer the shares first to the other shareholders. If the other shareholders do not buy the shares, the selling shareholder can offer the shares to third parties, including non-family members.

Since this is generally the main limitation provided by law on the sale of shares, families who wish to keep ownership of the shares within the family should consider contractual arrangements to ensure, to the extent possible, that this is achieved. Such contractual arrangements typically include a shareholders' agreement which provides a process for exits beyond the law and which binds the shareholders.

Some of the contents of a shareholders' agreement are further incorporated in the memorandum of association or articles of association, to the extent permitted by the notary public. The memorandum of association also binds the shareholders, and at the time of a shareholder's demise, a legal heir also becomes a party to it.

Documents recommended to regulate exits



Note: While the legal rounds described in the following pages apply to limited liability companies generally, the legal position may vary depending on the GCC jurisdictions, or the free zones in such jurisdiction

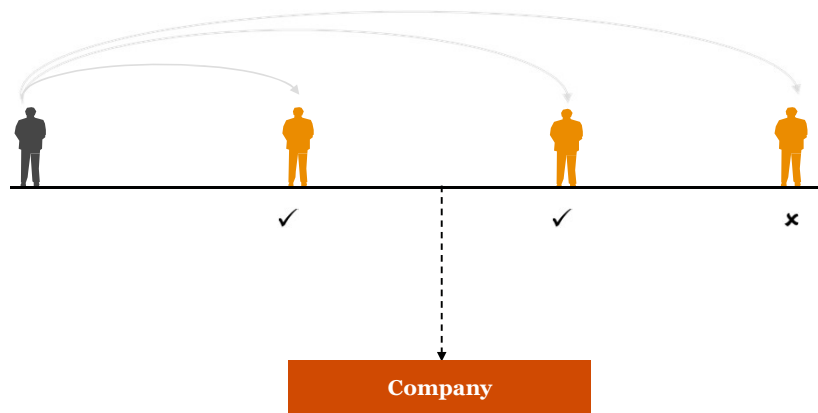
Illustrative example: Legal exit scenarios

Round 1 – Right of first refusal, in *law*

Companies Law requires that an exiting shareholder must offer his or her shares to other shareholders, giving them an opportunity to buy the shares. These shares must be offered in proportion to the existing shareholding of the other shareholders. If the other shareholders do not buy any or all of the shares, the exiting shareholder may sell the shares to someone else, unless there are further restrictions in contract (Round 2).

Where a shareholder cannot purchase shares due to lack of funds, the shareholders may agree that a mandatory dividend be declared immediately to facilitate the purchase of the sale shares.

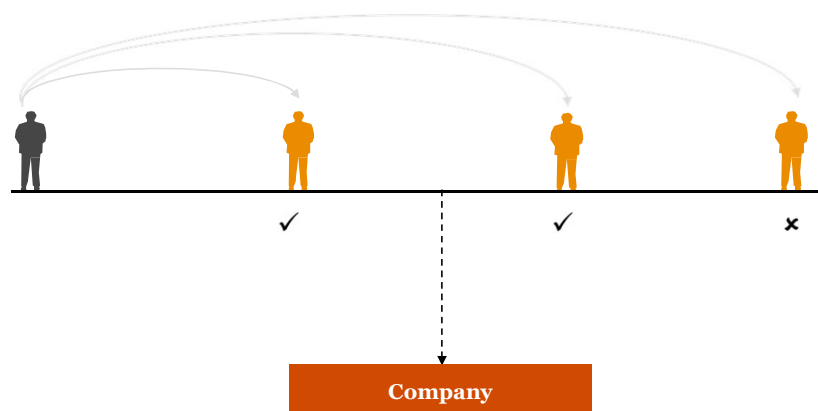
■ Seller
■ Shareholders



Round 2 – Further right of refusal, in *contract*

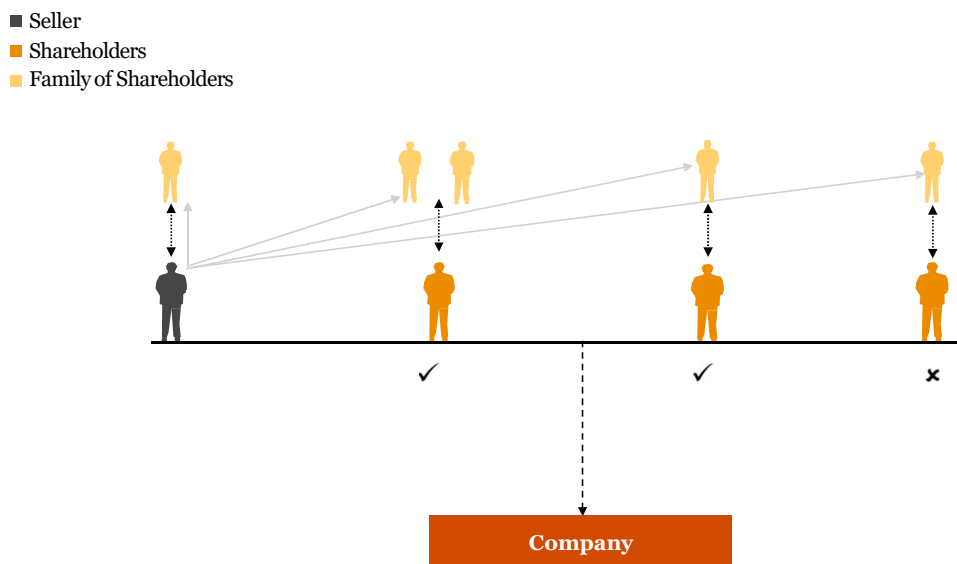
Where after Round 1 some or all of the shares are not bought by the other shareholders, and the family wishes to minimise the possibility of non-family members becoming shareholders in the business, the family may, in addition to the law, contractually agree restrictions on the transfer of shares in the memorandum of association or the shareholders' agreement. For instance, the shares that are not bought may be offered again to all the shareholders in proportion to their shareholding, giving the shareholders another opportunity to acquire the shares.

■ Seller
■ Shareholders



Round 3 – Wider family offering, in contract

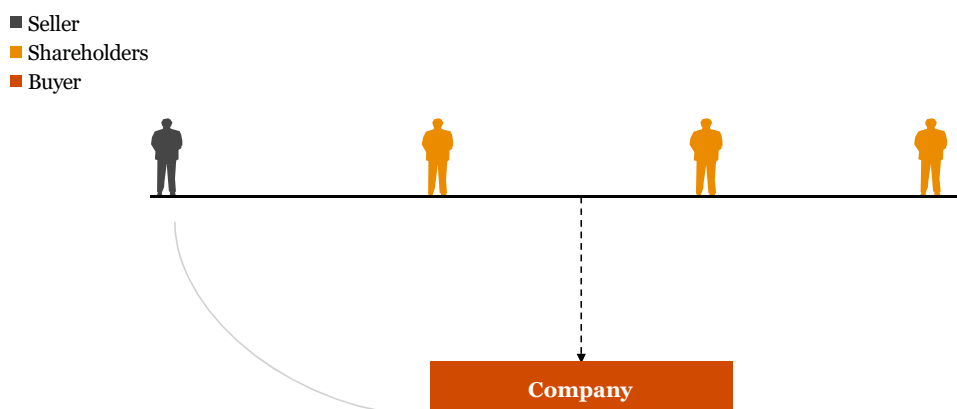
Where after Round 2 some or all of the shares are not bought by the other shareholders, such shares can be contractually agreed to be offered to a certain class of wider family members, for example the children of the existing shareholders, who will be offered the shares in proportion to the existing shareholding of their parent. This is a particularly attractive option where the second generation is mature and emerging.



Round 4 – Company buy-back, in contract

Where after Round 3 some or all of the shares are not bought by the children of the existing shareholders, it can be agreed by the company that it will buy its own shares from the exiting shareholder and the shares will be held by the company as treasury shares. The company of course needs to have enough reserves to buy its shares. It is important to ensure that the company is incorporated in a jurisdiction where the laws allow a company to buy back its own shares – i.e. most free zones and mainland UAE do not allow a company to buy back its own shares.

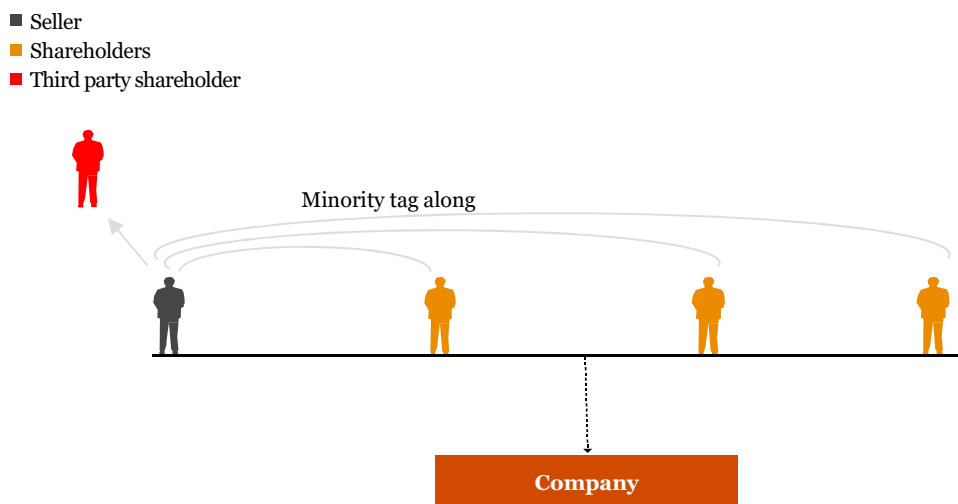
Where regulation does not allow a company to buy back its own shares, the company can still facilitate the purchase of the sale shares by the shareholders by declaring dividends, as detailed in Round 1.



Round 5 – Tag along right, in *contract*

Where after Round 4 some or all of the shares are not bought back by the company, perhaps because the company may not have enough cash available to purchase the shares or because it is not legally possible in the jurisdiction where the company is incorporated, then in the absence of any other contractual restriction the exiting shareholder may sell the shares to a non-family member.

Where the exiting shareholder holds a majority or large percentage of shares and intends to sell to a non-family member, the shareholders may agree to have a “tag along” right in the shareholders’ agreement that allows a minority family shareholder the option to tag on to a sale by a majority exiting shareholder. This is to give the minority family members the comfort that if the majority family shareholder exits, the minority can exit along with the majority shareholder, and not be left in the family business with a majority non-family shareholder.



Similarly, a “drag along” right may also be agreed for a majority shareholder exiting the business to force a minority shareholder in joining the sale. However, we do not see a drag along right commonly used in family businesses since keeping family members in the family business, even if a minority, is encouraged, rather than being forced out for the benefit of a majority shareholder.

Other contractual restrictions

- Restriction on sale cycles: Shareholders may agree to restrict the frequency of sale of shares (say, once a year only).
- Restriction on sale percentage: Shareholders may agree to restrict the number of shares a shareholder can sell in a year (i.e. no more than 10% of their personal shareholding).

Enforceability of contracts

Where an exiting shareholder does not transfer the shares as agreed in the shareholders’ agreement (in Rounds 2, 3, 4 or 5), the other shareholders may seek the remedy of ‘specific performance’ in the courts, requiring the exiting shareholder to comply with the shareholders’ agreement and to offer shares as agreed. The courts however can be inconsistent in awarding the remedy of specific performance, particularly where it would be “oppressive” for the exiting shareholder. In such cases, the courts may award monetary damages instead of specific performance of the agreement. However, monetary damages may not always be a suitable or satisfactory remedy.

Tax considerations in relation to an exit

With an increasingly complex regional and international tax landscape, there are often important tax implications and potential opportunities that should be considered in relation to an exit, even though tax is not always front of mind for business owners in the Middle East. This is particularly the case where the business and/or the individuals involved have a presence in taxing jurisdictions or, indeed, when the buyers themselves are based in taxing jurisdictions.

With appropriate planning, business exits can be structured such that any tax costs for sellers are mitigated as far as possible. A transaction is also an opportune time for sellers and buyers to implement longer term planning and arrange their affairs efficiently for tax and legal purposes.

Some key considerations are the following:

Optimising the tax position for the seller:

- Depending on the jurisdiction(s) where the business and/or the owners are tax resident, the seller could be exposed to tax on the gains and/or proceeds of sale. This could vary across different sellers (e.g. family shareholders) or could be indirect tax issues in the business that need to be understood.
- Planning in advance of an exit gives sellers the opportunity to plan the structure and/or the timing of the transaction in such a way that the tax position and use of any available tax reliefs is optimised.
- In some jurisdictions, it is also possible to seek advance clearance from the tax authorities to give comfort and certainty over certain aspects of the tax treatment of the transaction.

Tax reporting and compliance:

- It is important to ensure the business and the owner are fully aware of their tax and legal reporting obligations and file the required returns in the relevant jurisdictions in good time.

Tax implications for the business:

- In some jurisdictions, disposing of a business can give rise to tax charges at a corporate level as well as for the owners who are exiting. This potential exposure should be considered and managed where applicable and advice taken to mitigate the tax costs wherever possible.
- In order to maximise the business's sale value, owners should ensure all outstanding tax liabilities are settled and any potential tax issues are properly managed. This means the future buyer will be less likely to seek a price chip further down the line based on liabilities or risks which may be uncovered as part of the due diligence process.
- There are often also ways in which an exit can be structured (e.g. share sale vs. asset sale) such that the tax exposure for the buyer (e.g. taxes payable on the purchase of shares) can be mitigated. Assisting potential buyers to reduce their overall cost of acquisition by achieving tax savings wherever possible, can prove advantageous to sellers in commercial negotiations.

Planning for the longer term:

- Prior to an exit is often an opportune time for individuals to structure for the longer term, e.g. succession / estate planning. In many jurisdictions, there are benefits such as tax reliefs available if restructuring takes place while the individual still owns the business. Some jurisdictions also offer attractive tax and other benefits if the proceeds of a sale are reinvested in particular ways.
- It is also recommended to reconsider the individual's overall investment strategy, inheritance tax planning, wills and so on if their portfolio / asset composition has changed significantly following a transaction, e.g. holding cash rather than a business.

Safeguarding the future of family and business by setting good governance early

Case studies

Misaligned motivations and lack of previously agreed protocols can lead to family disputes

A case study of how the absence of properly defined guidelines can lead to conflict within the family:

Family business members can have differing views regarding how the company strategy is aligned with their individual goals. In this particular client situation one of the family members did not have any successors and hence felt that the long-term strategy which was adopted by the family business did not cater to his expectations. The majority of the family members recommended lower dividend payments in order to invest in sectors which would strengthen the family business in the long run. Disagreement between the siblings ensued over the dividend payments and a mutual agreement was reached for the discerning shareholder to exit the business.

However, the lack of pre-defined protocols and exit roadmap drove the process to a deadlock. During the negotiation process for the shareholder's exit, the company won a large government contract which required bank financing, and the bank required for the reserves of the company to be converted into capital in order to provide financing approval. The exiting shareholder refused to comply until a share price was agreed that was much larger than what a fair valuation would have indicated. The emotional distress, lengthy negotiation process, family disharmony, and ultimately, unsatisfying commercial outcome could have been avoided if appropriate protocols and exit / valuation methodology had been agreed prior to the emerging exit scenario.

Proactiveness is the foundation for a smooth transition through times of change

A completely different picture is painted in the case of a family that chose to develop early on the appropriate governance tools.


Following the decision of the founding father of a family business to retire and pass the baton to the second generation, the family protocols and shareholders' agreement were developed. Detailed processes that aimed to safeguard the future of the family business and protect the individual interests were agreed by all family members. The protocols were signed by all second generation family members and included exit methodologies and agreements on how a valuation may be conducted.

The protocols were utilised many years later when indeed an exit of a family member arose and an amicable separation that was agreed by all was reached due to the methodology that was previously defined and agreed by all.

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Establishing good governance is part of the professionalization of every family businesses. The internal dynamics and entrepreneurial character that distinguish family businesses may be well preserved, but a pragmatic approach on how to deal with future change and how to adhere to unemotional processes is a necessity.





**What family businesses
should consider now to
successfully navigate change
in the future**






Call to action

Exits are an inevitable part of the business. It is important that family member exits are handled in a professional and fair manner to avoid conflict. A sound preparation is crucial to ensure that the business can continue running without disruption, mitigate any risks, and achieve the maximum value from the transaction in the case of sale to a third party.

Roadmap to success:

- **Governance:** Having the proper governance framework in place is the guideline that can help a business navigate an exit process smoothly. This framework can be provided in the family protocols or family constitution and can include a valuation methodology that is agreed by shareholders.
 - **Legalization and enforcement:** It is strongly recommended that governance frameworks are made legally binding and indisputable through the memorandum of association and shareholders' agreement.
 - **Corporate structure:** Designing a strategic corporate structure to allow ownership and exit at a central level, i.e. a holding or sub-holding company where there are different business streams.
 - **Right exit route:** Understanding and aligning the motivations and goals of the family, the business and the departing shareholder help identify the right exit route and the right way forward.
 - **Transparency:** Achieving transparency in a necessary yet comfortable level is key for a family business to ensure they have access to the most suitable investment options.
 - **Communication:** A clear communication strategy and a defined change management process during the transition phase can provide a smooth journey into a new status quo.
 - **Advisors:** Finally, the support of the right qualified professional service advisors can help family businesses maximise the value they are looking for.
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About Family Business Council – Gulf

The Family Business Council – Gulf (FBCG) is a private not for profit organization aiming to strengthen family business governance and ensure their continuity over generations. The council seeks to identify and address issues unique to the GCC region through research, education, capacity development, and networking among peers. FBCG is a member of a worldwide organisation - the Family Business Network International (FBN) - the largest global network 'by families, for families' representing leading family businesses all over the world.

For more information, visit www.fbc-gulf.org.

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