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How much can the venture capital industry grow in Saudi Arabia by 2025?

STV Insights Report

October 2019

Executive Summary

Venture capital (VC) investments in Saudi Arabia are growing rapidly, and yearly invested capital has the potential to expand tenfold to $500 million in 2025 from $50 million in 2018. The realization of such a growth trajectory will result in a cumulative injection of $2 billion between 2019 and 2025. Of that total, STV estimates that $350 million will target early-stage ventures, with the rest deployed across the ecosystem, from Series A to late-stage ventures.

An aggregate annual VC ticket size of $500 million would align Saudi Arabia to countries where the VC industry has played a significant role in the economy – countries such as France, South Korea and UAE where VC's annual investment is equal to 0.1% of the GDP. Reaching $500 million by 2025 implies an average yearly growth rate of 40% over the next 7-years – a trajectory other countries have achieved, and an ambition Saudi Arabia appears capable of achieving.

Furthermore, Saudi Arabia's status as the region's economic powerhouse indicates a clear opportunity for the Kingdom to capture its fair share of MENA VC investments compared to GDP. This would have been the equivalent of $235 million in 2018, assuming it secured 35% of MENA-invested capital, in line with its share of regional GDP.

We believe Saudi Arabia is now on the cusp of realizing this potential for the following reasons:

1. Strong demand for tech products from consumers, businesses and the government
2. Recent exits have validated the VC model in the region, while successful Saudi-born tech solutions have enhanced the technology sector's appeal to talent
3. The tech ecosystem and value chain are developing rapidly as enablers that accelerate the formation of digital ventures are established
4. A growing presence of incubators and VCs has positively contributed to the maturity of the ecosystem
5. Ease of doing business has improved significantly in line with new entrepreneur-friendly regulations

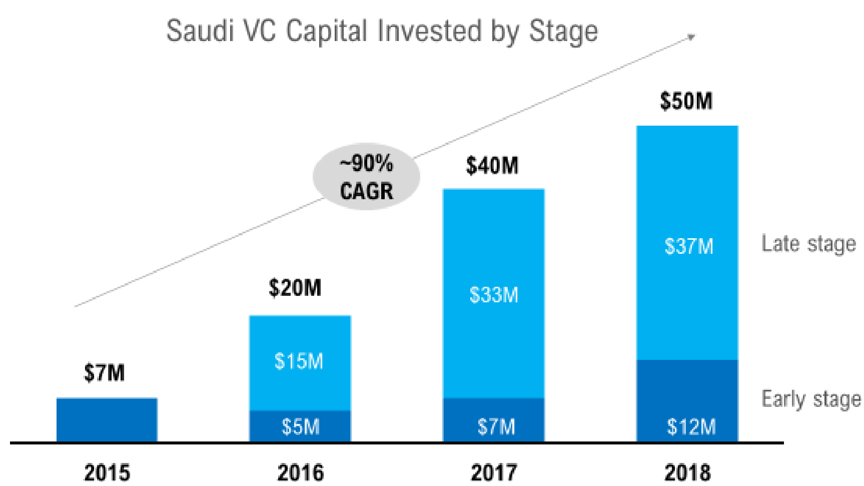
A number of critical changes are required to support the ecosystem's growth. Among these are amendments to the Saudi Companies Law and legislation to allow the enforcement of the kind of debt instruments that VCs are more familiar with in more mature markets. Rolling these out will go a long way towards channeling investments for seed and early-stage startups. The availability of talent also remains a primary bottleneck, but Saudi youth are motivated and inclined towards tech and enterprise, and coupled with access to the virtual education resources, we expect this gap to narrow in the near future.

Despite these challenges, the Saudi Arabian start-up scene presents attractive investment opportunities for VC funds, thanks to new government regulations, a maturing value chain, and most of all, a fast-expanding market for tech.

Venture capital investments in Saudi Arabia are growing rapidly…

VC activity in Saudi Arabia is booming following a recent surge in activity. VC investments grew to $50 million in 2018 from $7 million in 2015, publicly available data shows. That is a 90% jump in CAGR over the last three years, deployed across approximately 90 ventures. The figure likely reflects only a portion of actual investments, as many seed and early capital injections remain unreported. [1]

VC investments in Saudi have grown from $7M in 2015 to $50M USD in 2018



Source: Magnitt Data, STV team analysis

…and there's room to grow tenfold, benchmarks indicate

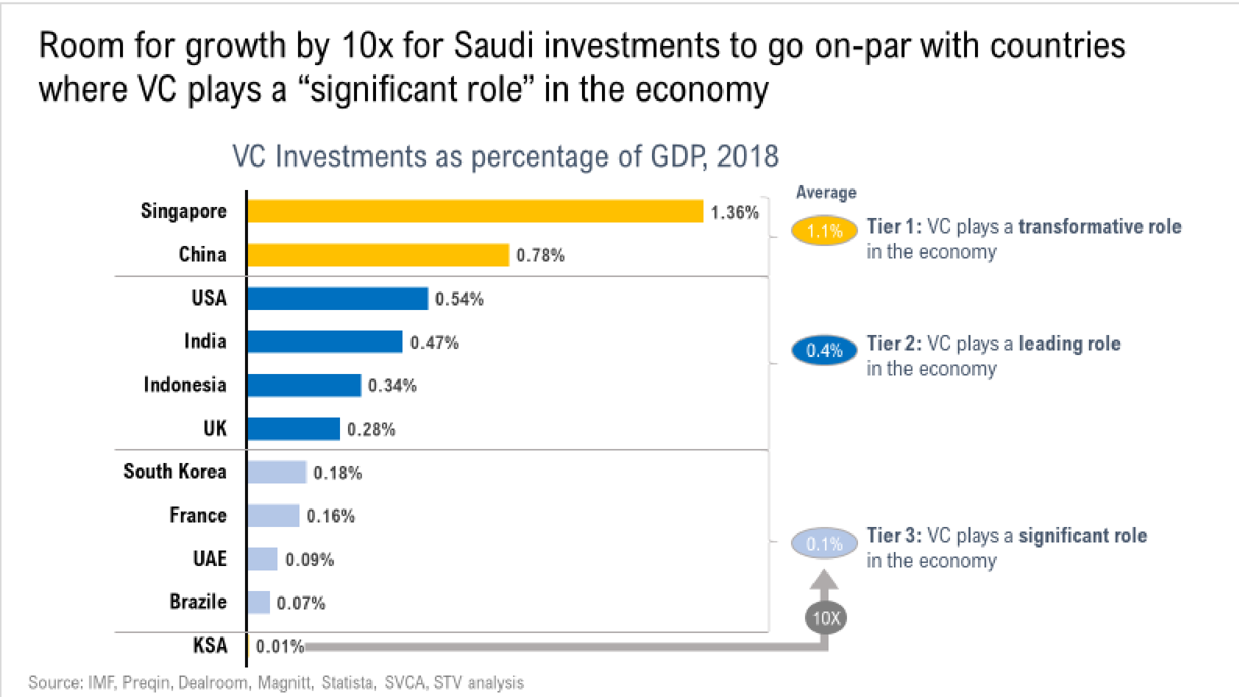
STV analyzed the ratio of VC investments in Saudi Arabia to national GDP to determine the industry's potential economic impact in the country. At 0.01% of GDP in 2018, the industry has substantial room for growth within the Kingdom.

By contrast, for countries such as Brazil, France, and the UAE—where VC plays a significant role in the economy—the ratio averaged 0.1%. In countries where VC is a leading economic

1 Obtaining accurate data in the sector has always been a challenge, but the figures offer a broad picture of VC activity. As such, STV uses the data to analyze market activity; this report does not aim to offer precise statistics on investment volumes.

force, the ratio stood at 0.4%. And, in countries where VC plays a transformative role, such as Singapore and China, the ratio was 1.4% and 0.78% respectively.[2]

Realizing Saudi Arabia's potential in accordance with the average ~0.1% ratio means that VC investments in Saudi must grow tenfold to reach $500 million per year.



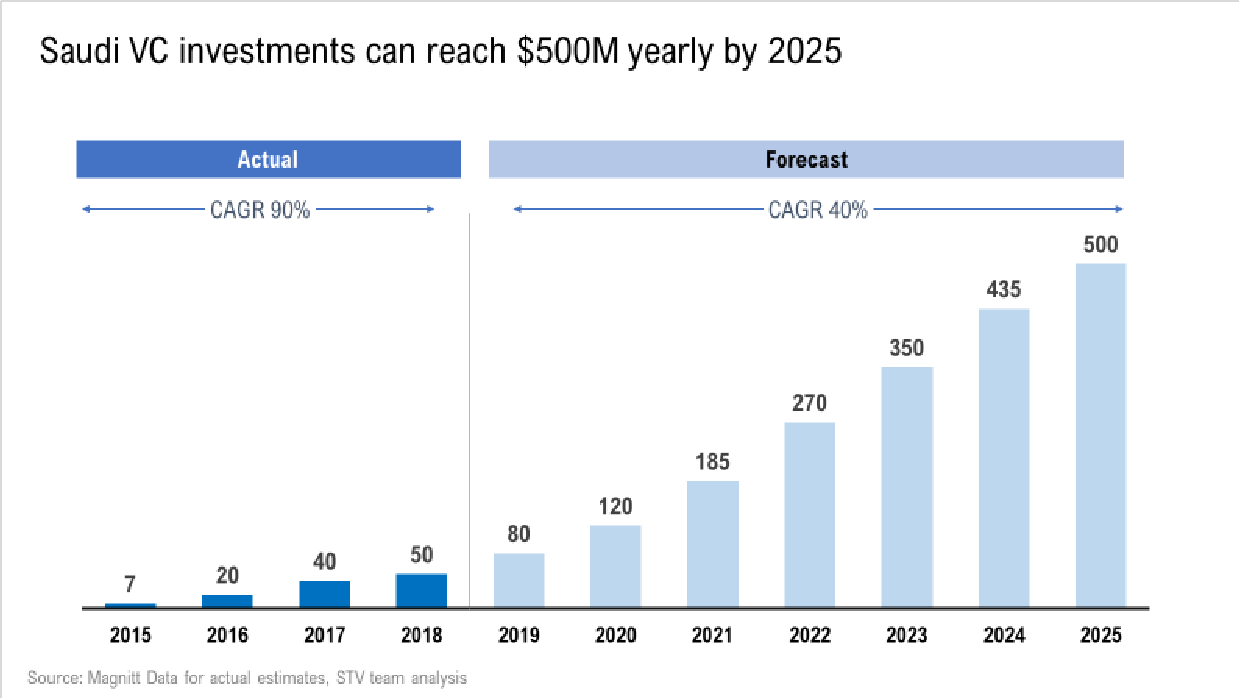
Saudi VC investments can reach $500 million by 2025

The forecast of $500M yearly investment by 2025 is supported by recent growth trend recorded by Saudi VC investment and by the growth rate recorded by benchmark countries.

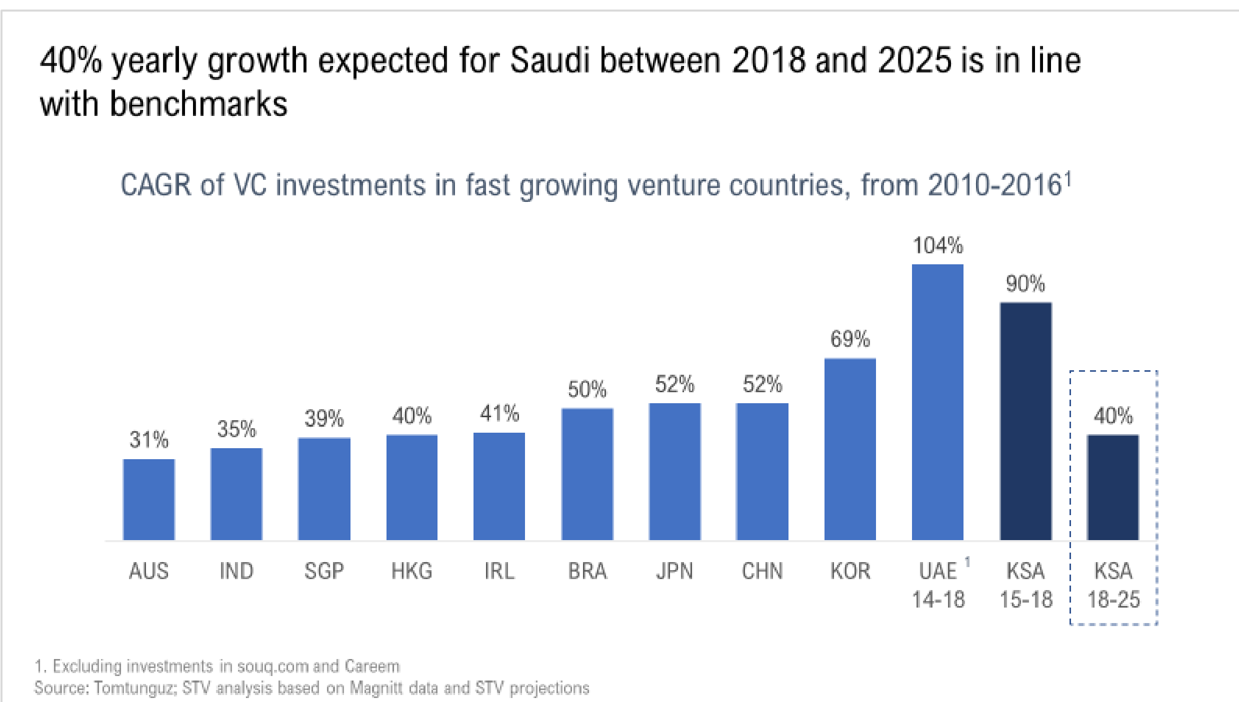
VC investments have been expanding by 90% annually between 2015 and 2018. This upward trend continued in the first half of 2019, with a growth rate of 82%[3] compared to the previous semester. We should expect growth to slow down as the absolute amount of invested capital increases. An assumed CAGR of 40% between 2018 and 2025 implies a drop in the yearly growth rate from 90% in 2018 to 15% by 2025. The realization of such a growth trajectory will result in a cumulative investment of $2 billion over the forecast period.

2 For the purposes of this report, STV uses the term significant to indicate aggregate VC investments valued up to 0.25% of GDP, while leading refers to investments valued between 0.25% and 0.75%. When VC investments cross 0.75% of GDP, they are described as having a transformative impact.

3 According to Magnitt

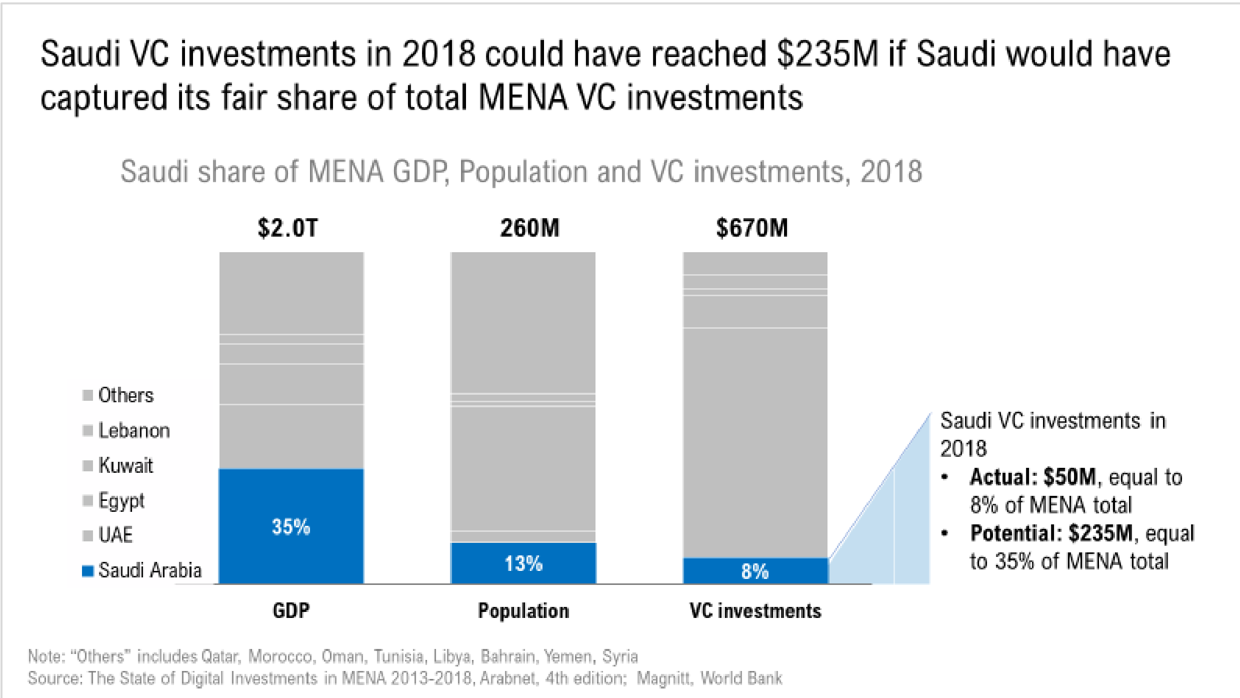


We believe that this forecast provides a reasonable projection, considering the many positive policy changes and incentives driving Saudi Arabia's VC market today. Furthermore, the VC industry has already demonstrated its ability to sustain high growth rates over a prolonged time frame in other economies, both emerging and more mature. Our findings confirm that the 40% yearly growth expected for Saudi Arabia can be surpassed. The following chart demonstrates that those trends are not uncommon, especially in fast-growing markets.



Saudi Arabian VC could have been 6x larger

Saudi Arabia has a clear opportunity to boost VC activity. In 2018, only 9% of regional VC funds were deployed in the Kingdom, although the economy accounted for 35% of the MENA total. If VC investments in the Kingdom were in line with its relative GDP weight, they would have accounted for $235 million, or more than 6x 2018’s $50 million investment.

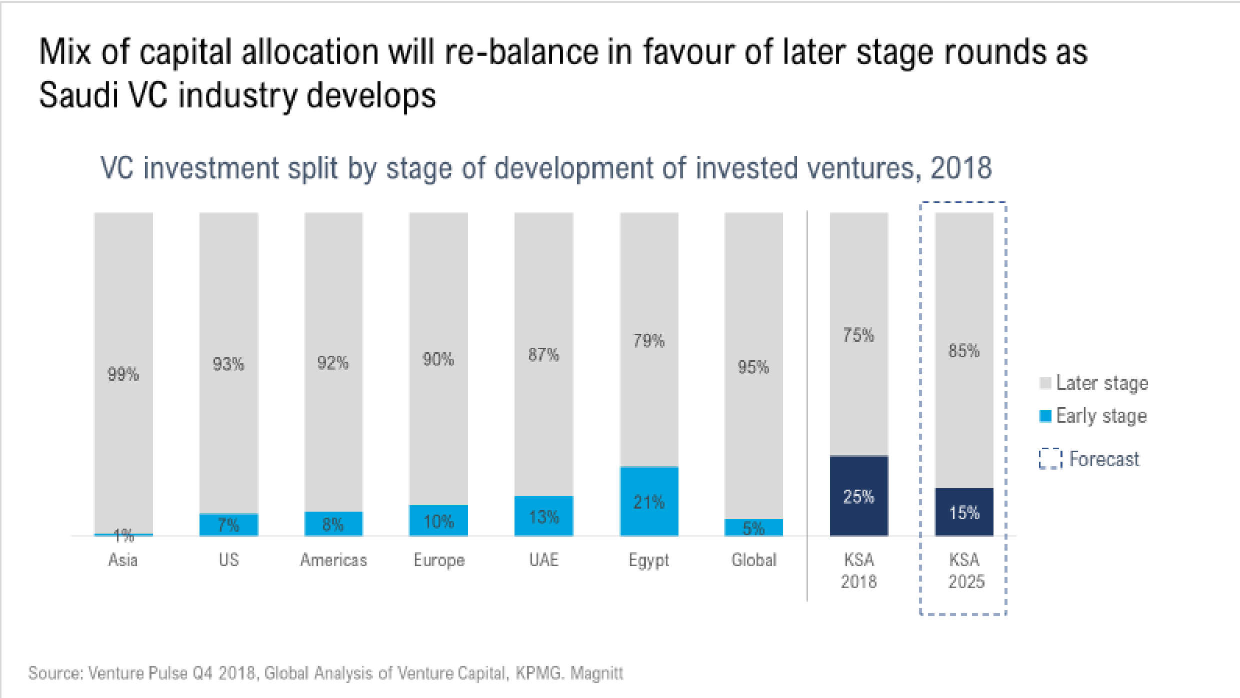


Almost 70% of MENA VC investments were deployed in the UAE over the study period. That’s perhaps understandable as the UAE has consistently facilitated access to talent. It has also fostered an active ecosystem through favorable regulations and a startup-friendly environment that incentivizes entrepreneurs to choose the country as their launchpad.

However, owing to its economic heft, its people’s purchasing power, and the changing entrepreneurial landscape, Saudi Arabia is emerging as the largest market for ventures in the MENA region, and is the market that can allow companies to scale exponentially. As the Kingdom continues to realize the economic benefits of its Vision 2030 reforms, we expect to see more businesses gravitate towards Saudi Arabia, as we have seen with Amazon.com and the San Francisco startup Cambly, an English-language learning community. Such activity will no doubt further support Saudi Arabia’s VC growth.

Capital allocation will swing towards later-stage investments

As the VC industry develops, a higher number of ventures will qualify for follow-on investments. Consequently, the sector will naturally rebalance towards later-stage investments, further aligning with mature markets.



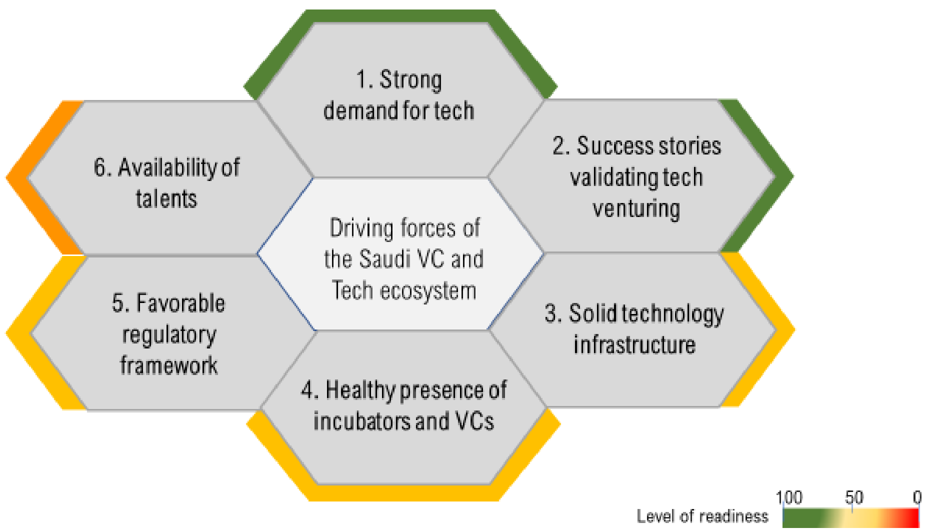
We estimate that the share of investments in *early-stage* versus *later-stage* ventures will decrease from the 25% recorded in 2018 to 15% in 2025. This trajectory will result in $350 million invested in *early-stage* ventures as compared to $1.6 billion in *later-stage* activity over the years from 2019 to 2025.

The maturing ecosystem creates favorable conditions for our forecast

Saudi VC investment growth recorded over the last three years has been propelled by many forces. Established industries such as agriculture, transportation, logistics, and healthcare are being transformed by local and regional startups. Many other sectors are ripe for disruption.

We see significant and positive development across the six main dimensions that determine the VC industry’s ability to flourish. Those dimensions, or growth pillars, summarize why we are confident that the future of Saudi Arabia’s VC and tech ecosystem will only get better.

Key pillars to a growing Saudi VC and tech ecosystem



Source: STV Analysis

1. Strong tech demand from consumers, businesses, and government

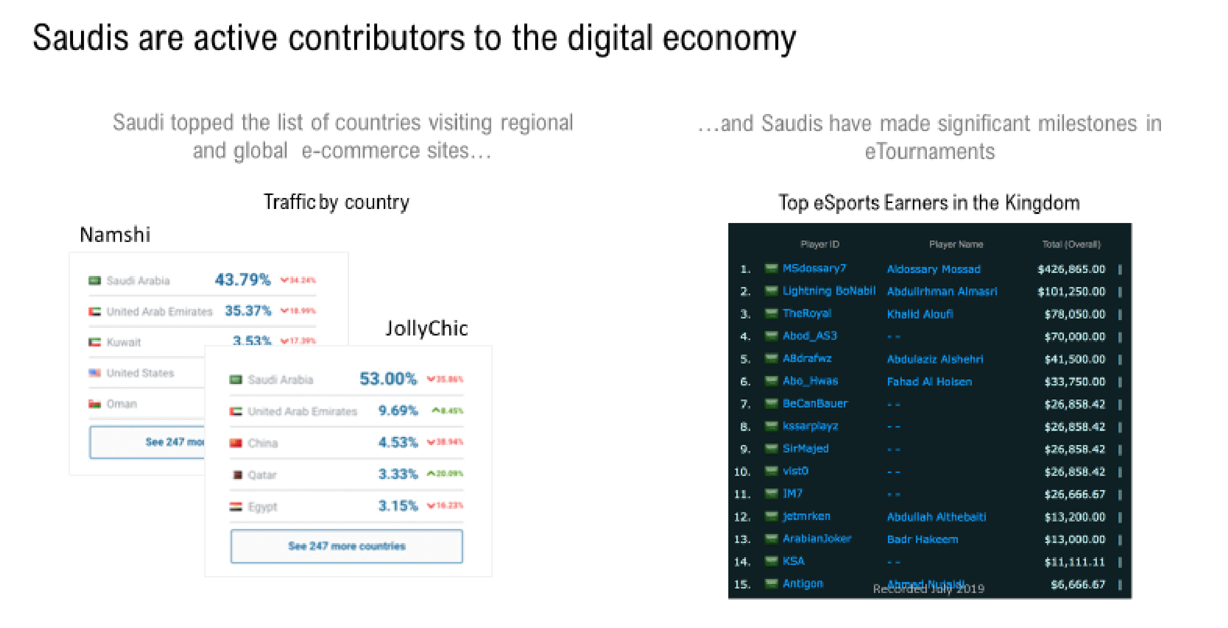
Demand for smart tech solutions to meet lifestyle choices among Saudi consumers has been a major driving force for the development of new products and services. The fact that Saudis are connected and extremely tech-savvy is not surprising. It is not uncommon to see Saudi Arabia topping the charts for smartphone penetration, YouTube views, or Snapchat consumption. Saudis, today, are also active contributors to the digital economy, led by the growth of the wider ecosystem.

Signals of this behavioral shift are plenty, and the evolution of Saudi consumers’ role in the digital economy has been impressive. The E-Commerce in MENA report developed by Bain & Company[4] indicates that the average basket size for online purchases today in Saudi Arabia is

4 Bain & Co E-Commerce in MENA Report

around $150—akin to mature markets such as the US and UK and greater than the average Chinese basket of $100. Amazon's acquisition of Souq.com and its recent hiring push confirms the opportunity that the e-commerce giant sees in the country.

Saudis are also now earning through online channels, whether through eSports or on platforms such as YouTube. The gig economy is providing new revenue streams to the Saudi population. Examples include apps such as ride-sharing platforms Uber and Careem, and delivery platform Mrsool.



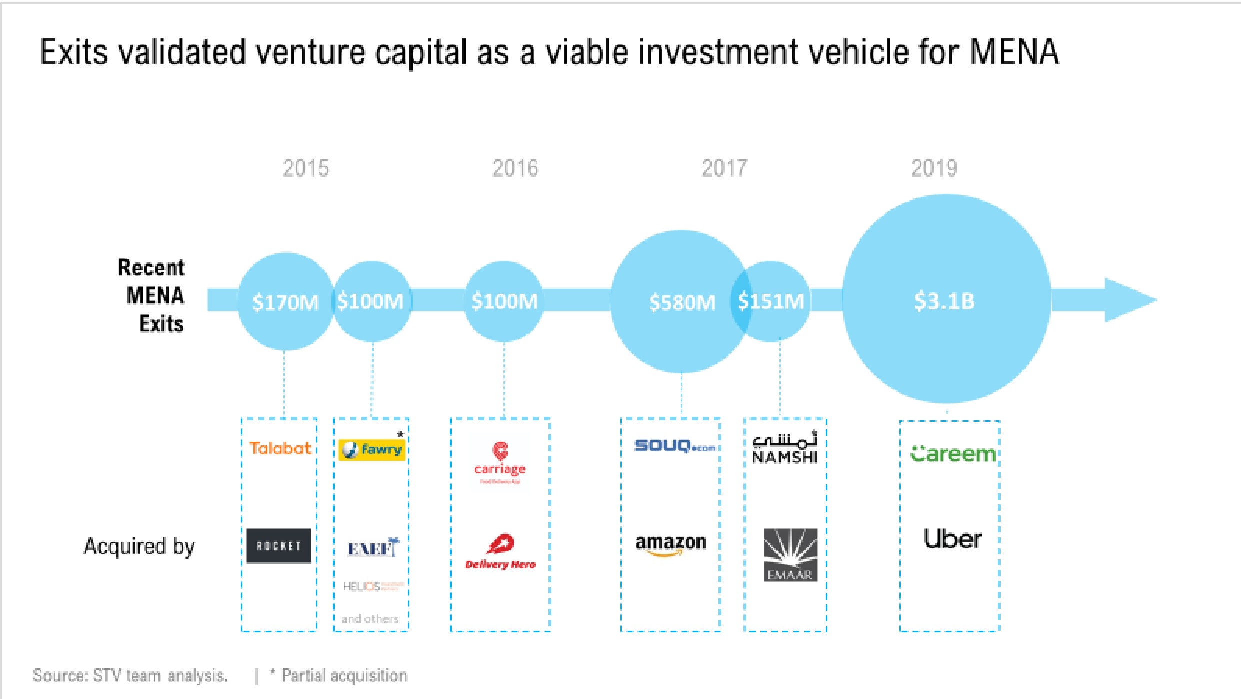
Source: SimilarWeb, STV team analysis

Across the Kingdom, business and government entities are embracing startups as well. This is seen as more established institutions and governments begin to work with technology-first startups and integrate them into their business operations. Startups such as Unifonic, the cloud communications platform, and Lucidya, the Arabic-focused social media analytics tool, are partnering with Saudi Arabia's most well-established institutions and government entities. As a result, trust in these and other emerging players is further solidified.

2. Success stories are feeding tech optimism among talent and investors

Startups like Noon Academy have shown how homegrown enterprises can expand from Saudi Arabia into the rest of the region, and not only vice versa. Unifonic, for example, has a demonstrated legacy of making cloud communications more accessible, and its services are used by international companies such as Aramex and Uber, and regional organizations such as Bank Albilad and the Saudi German Hospital.

Success is also being seen in other ways. Exits such as Souq.com (acquired by Amazon for $580 million), Careem (acquired by Uber for $3.1 billion), Carriage (acquired by Delivery Hero for $100 million), and Talabat (acquired by Rocket Internet for $170 million) have validated venture capital as a viable investment vehicle in the region.



As A16z's Marc Andreessen puts it, software is finally eating the world—a state of affairs that is now being replicated in the Kingdom. As the momentum continues to grow, we foresee a healthier pipeline of early-stage startups that can translate to later-stage investable companies, further raising prospects for Saudi VC investments in the medium- and long-term future.

3. Technological infrastructure are enabling even more start-ups

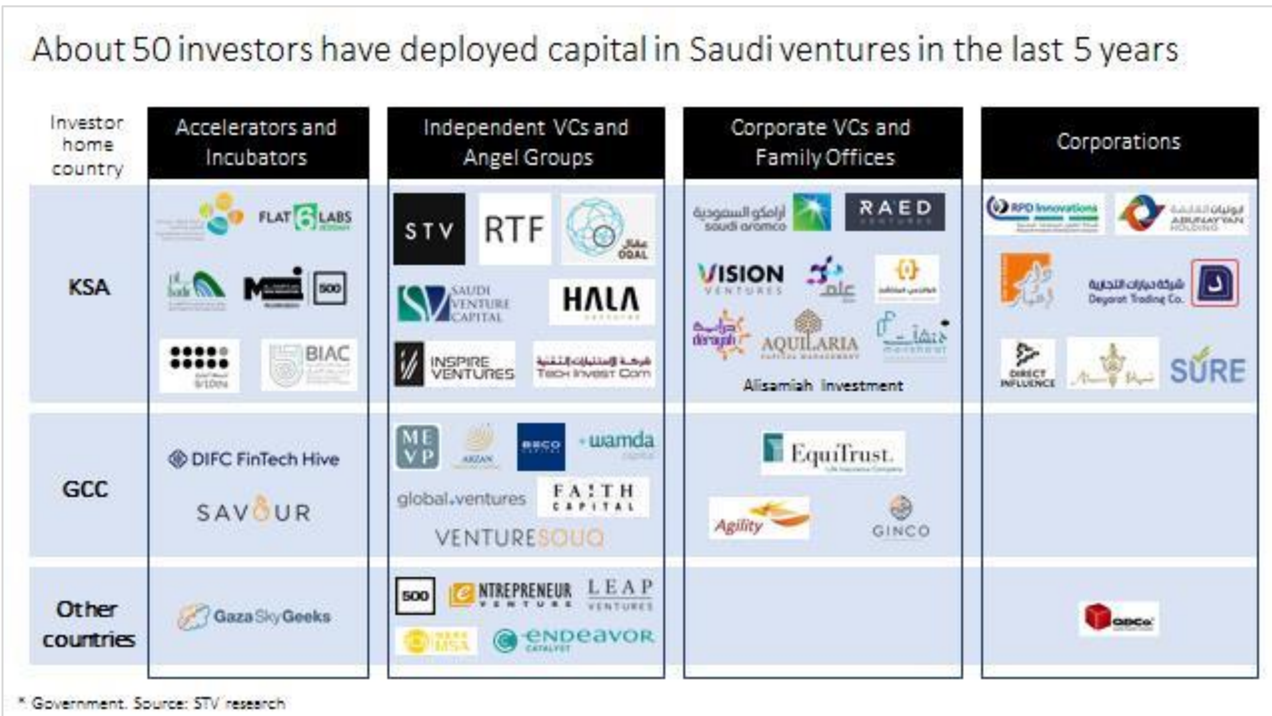
The advent of new infrastructural platforms has enabled a new class of entrepreneurs. Thanks to simplified retail solutions such as the digital storefront site Salla and logistics fulfillment company Salasa, anyone can now launch an e-commerce business within a matter of days. Salla, for example, already has 8,000 digital shops. In line with disruptive digital trends worldwide such as Shopify, this is only the beginning of Saudis' engagement with the digital economy.

Payment solutions remain an important link in this value chain. From STC Pay to PayTap and Hyperpay, we see a lot of developments in the space. However, we are eager to see a regional leader that can further unlock the digital economy in Saudi Arabia, the GCC and the wider MENA region.

4. The healthy presence of VCs and incubators is growing fast

In recent years, an increasing number of investors have been looking at Saudi Arabia's youth-led demographics to create value. Consequently, more VC capital has made its way into the Kingdom.

The Saudi Venture Capital Company (SVCC) is among those companies that are actively enabling the ecosystem. It does so through direct co-investments with angel investors, venture capitalists, and sophisticated investors, and by investing in VC funds to catalyze venture capital investments and entry barriers for fund managers looking to operate in the VC market. STV is seeing more initiatives and policies that are further driving this growth.



5. Favorable regulation has significantly improved ease of doing business

The Saudi government has made great strides to unlock the nation's digital and entrepreneurship ecosystem's potential. Recent policies such as the permanent residency program and expat ownership licenses will encourage entrepreneurs to choose the Kingdom as a startup base. Foreign founders can now apply for residency permits along with their families, own real estate, and have 100% corporate ownership in sectors such as education and healthcare. Most, if not all, of the tech ventures established in the region target the Saudi market. Many have already begun scaling up their operations in the Kingdom. Allowing those ventures to set up and fully run their businesses from Saudi Arabia will be a real turning point for the ecosystem.

The Kingdom’s new bankruptcy and commercial pledge laws fill important gaps in the legal infrastructure. SAGIA’s new *Venture by Invest Saudi* will attract greater numbers of venture capital firms to the Kingdom, enabling entrepreneurial activity to flourish. This is a significant step forward for the ecosystem and a critical channel that will funnel valuable know-how and experiences from global VCs to local entrepreneurs. SAGIA also introduced the Entrepreneur License last year, to allow foreign founders to launch and expand start-ups in the Kingdom via co-working spaces and accelerators.

Fintech Saudi is accelerating the development of the financial services sector with its sandbox initiative, sharing frameworks and regulations, as well as providing options for international players keen on reaching the Saudi consumer. This can unlock potential not only within fintech, but also for many other sectors that rely on payments and financial solutions.

We also see greater potential across the GCC. Regulatory changes that can enable seamless cross-border transactions and operations will deepen existing synergies and allow local players to go regional — further tapping into resources and value pools across the GCC.

But there’s room to improve even further.

The time needed to complete a financing round can be cut significantly if Saudi Arabia is able to implement its own financial free zone, along the lines of the Abu Dhabi Global Market (ADGM) or the Dubai International Financial Center (DIFC). Such a move would mean that Saudi Arabia would not lose business to other jurisdictions. We also see room for improvements in capital requirements. Startups today are hindered by high minimum share capital requirements.

There’s also significant room to strengthen the legal infrastructure. Convertible notes and simple agreements for future equity (SAFEs) are unenforceable in Saudi Arabia. These instruments are the basis of most seed and early-stage financing and are very important to the health of new ventures. Employees' Stock Ownership Plans (ESOPs) do not exist under Saudi law. ESOPs are a virtue of start-ups around the world and are an essential way for tech companies to attract new talent. Finally, Saudi Arabia would also benefit from developing Preferred Shareholder Rights (PSRs). The vast majority of VC financing includes a standard suite of PSRs, including liquidation preferences and anti-dilution rights, which do not exist in respect of a Saudi entity.

The Saudi Companies Law requires amendments in order to ensure that these standard VC structures are available and enforceable in the Kingdom.

6. There’s a shortage of talent—but that could soon be fixed

The continued growth of the start-up ecosystem depends on sustained entrepreneurial activity. Beyond measures to build startup interest, finding and creating a talent pipeline remains the main enabler of a truly vibrant and fast-growing ecosystem. Demand for talent is not unique to Saudi, however, the gap between the supply of talent and demand from both local and global tech companies is widening fast.

But there's a light at the end of the tunnel.

As skills become obsolete ever more quickly, the tech industry has begun to increasingly rely on talent with an entrepreneurial spirit rather than counting entirely on seasoned professionals. A study published by Deloitte finds that the Saudi Youth have a much stronger motivation towards tech entrepreneurship compared to their international peers. STV research is proving that to be true on the ground as well. We have met with hundreds of Saudi founders who showed both the will and commitment to solve some of the most pressing problems facing the Kingdom and the wider region by leveraging the power of technology. These success stories, coupled with mentorship and youth engagement programs, can provide the inspiration and motivation needed for Saudi youth to take the leap into the startup world.

The tech industry also relies on a consistent supply of highly skilled engineers, product managers, business developers, and sales professionals. The internet offers innumerable ways for anyone with a device and a connection to acquire hard and soft skills. Whether these programs are self-taught or tracked, free or paid, locally produced or globally, they can help virtually anyone to build a relevant skillset for building digital ventures in as little as six months.

Several measures are already in place to tackle the shortage of human capital, often cited as the main obstacle for the development of technology ventures. Thus far, the government has played a central role in developing education, investing 25% of all spending in learning and development, with a particular focus on the integration of technology, AI, and digital skillsets into university curricula. However, investors and fast-growing tech companies also have a role to play in developing local talent and skilled professionals for Saudi Arabia’s start-up sector to truly unlock its potential and leverage that value for future generations.