Interpreting Convertible Notes

Exploring alternative fund raising investments in Bahrain for Closed Joint Stock Companies
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This document serves as a guide for startups that are looking to issue Convertible Notes in the Kingdom of Bahrain. The guide provides an overview of the Convertible Notes, the associated benefits of utilizing such financing instruments for both startups and investors, as well as the key terms. The guide also provides an overview of the legal and regulatory framework in the Kingdom of Bahrain.
Internationally, Convertible Notes have become an attractive option to raise capital for businesses, especially start-ups and small to medium enterprises. Over the years they have evolved into more modern, simpler to use capital raising instruments. Convertible Notes do not have a specific form and can be easily drafted to ensure that they are aligned to local, regional and global regulatory norms.

The Commercial Companies Law of 2001 (CCL) in Bahrain was amended with regards to issuance of convertible note securities (also referred to as Convertible Notes) by closed joint stock companies. The amendment is a positive step towards facilitating the fund-raising process for private companies, placing Bahrain in the forefront as the first and only onshore jurisdiction in the Arab world to legislate for and allow Convertible Notes.

With this publication, we aim to provide an overview and some clarity that will help simplify the concept and the approach to Convertible Notes for business owners who are considering issuing Convertible Notes. It also helps, if the process owners have the right advisors to help them navigate through these complexities while they proceed to raise capital. With the right approach a business owner can raise funds while reducing their overall cost of capital and in the process enhance their shareholder value.

Nicolas Ribollet
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KPMG in Bahrain
Convertible Notes

General Overview

Convertible Notes are commonly used and have become the preferred fundraising instruments by startups and early-stage companies that have not yet commenced priced equity funding. Such early phase funding and financing is usually conducted with and targets the startup’s founders’ family and friends, some high-net-worth individuals, family offices, as well as angel investors and venture capitalists. In some instances, more mature companies that are close to listing also revert to this fund-raising tool to fulfill expenditure requirements building up to the listing.

Convertible Notes, in simple terms, are instruments enabling an investor to provide a loan to a company, with the purpose for it to be ultimately returned by the company in the form of equity. Convertible Notes are originally structured as debt investments but have provisions that allow the principal plus accrued interest to be converted into an equity investment at a later date.

In essence, a Convertible Note is a loan note or bond issued by a business (borrower) to an investor (lender), which would convert into equity when a predetermined trigger event occurs. For a business a Convertible Note is an instrument addressing investors’ risk return expectations and facilitating the funding requirements of the business. It is relatively efficient in terms of time, money, as well as the procedural formalities to put in place. They are also robust enough to be used for ‘early-stage’ businesses as well as more mature organizations in need to raise funding between rounds of equity, or for those looking to get listed as part of their ‘pre-listing’ round.
General overview

Pre-seed funding

A key challenge to entrepreneurs when starting a business is raising ‘capital’.

The earliest funding round to assist startups with its initial formation is known as ‘pre-seed’ funding, with the customary amount of capital raised in this round being up to $50,000. The investors in pre-seed funding are commonly the founders themselves, as well as their close friends, supporters and family members.

Funding rounds (Seed Round, Series A, Series B and Series C etc.)

The influx of capital from the pre-seed funding enables entrepreneurs to get their operations off the ground. However, businesses will soon thereafter require and look to raise further capital to finance the product or service development and launch. The subsequent round of funding that a startup completes is commonly referred to as the ‘seed round’. A business usually raises seed round funding to accelerate its growth, i.e., by hiring more talent to develop the product. Seed investors typically include founders, high net-worth individuals, venture capital companies and/or startup accelerators.

Businesses that demonstrate a viable product or service usually seek a timely infusion of further capital from subsequent funding rounds to promote growth. Business growth in this context may mean expansion of facilities, purchase of supplies, equipment and machinery, increased hiring of personnel and/or gaining access to new markets. Multiple rounds or ‘Series’ of subsequent funding are commonly referred to as Series A, Series B, Series C and so on; with the letter expressing the number of rounds used by a startup to raise external funding. Later round Investors may range from Private Investors to Banks and Financial Institutions, Private Equity funds, Hedge Funds and even Sovereign Wealth Funds. The pricing, generally, for later rounds of fundraising tend to have a premium associated to it based on the performance of the business.
Benefits of Convertible Notes

To Businesses (issuers / borrowers)

Relatively simpler and faster process to get initial financing: Convertible Note agreements are typically straightforward and simpler to document from a legal perspective compared to other options, i.e., a preferred shares financing deal, which may take up more time and money due to its more complex nature. Therefore, opting for a Convertible Note would result in a quicker and easier exercise when compared to negotiating a priced equity round, with the deal completing immediately and the loan being advanced as soon as the Convertible Note is signed without the need to wait on factors such as co-investors signatures and satisfying pre-conditions common to share issuance procedures. When it comes to startups in specific, this allows for the avoidance of having a complicated financing structure at the onset.

Lower fees and costs: This in turn means that the process is also less expensive as professional advisors play a smaller role resulting in lower legal and other professional costs.

Flexibility and no loss of control: Not giving away direct ownership and voting rights allows Startup owners to delay relinquishing control of the business up to the time of conversion.

Delaying valuation: Utilizing Convertible Notes would allow startups to postpone valuation of the company. This is important because:
- Placing a value on a startup before the company had the chance to show traction in terms of product and/or revenue can be difficult to achieve with no sales and operational history. Delaying valuation allows startups to value the company in a more accurate and appropriate manner at a later stage. This also allows for the avoidance of overvaluation of a startup company with limited data as to performance.
- Valuations, with the lengthy debates and negotiations that are inevitable in the valuation process, may be time consuming and expensive (involving valuation advisors’ fees and professional costs).

Additional cash for product or market development. Getting a reputable Investor(s) on the books.

Remaining private for as long as reasonably possible and avoiding the compliance costs and disclosure obligations of a listed entity (pre-listing companies).

Addressing concerns of the investors including risk and return appetite.

To Investors (lenders)

Access rights: Prior to the later rounds of financing, the Investor would usually have regular access to information rights, which may include the right to view the business’ periodic financial statements, as well as annual operating budgets and financial forecasts.

Knowledge on the startup’s status: The Investor would have built a relationship with the founders and employees of the business and, therefore, would be familiar with their collective capabilities and strengths. Accordingly, once the business has developed an established user base and consistent revenue figures and is poised to receive additional funding to expand the business past the development stage, the investor will be in the most advantageous position when it comes to deciding whether to expand their shareholding equity in the startup.

Recovery of capital in the event of insolvency: Whereas Convertible Notes are debt instruments, they would have higher ranking than equity in case of insolvencies. Accordingly, when a startup is faced with a liquidation or bankruptcy order, holders of Convertible Notes would be entitled to recover the amount of their investment (subject to the proceeds being sufficient to do so) before common shareholders receive any of the proceeds. This is commonly referred to as having seniority over other shareholders, who are usually the founders and employees in case of startups.

Pricing negotiations at early stage of investment in startup: As seed investors, the investors may, as part of terms of Convertible Notes, negotiate certain preferred pricing arrangements for subsequent Series of funds raised by company.

Ultimately, Convertible Notes enables investors to realize the growth and valuation potential of the company in best outcome scenario whereas restrict its losses in case of insolvency.

Note: A business valuation needs to take place at some point, including costs associated with this exercise. This is why pre-seed or seed rounds are also referred to as ‘bridge’ financing leading and up to the priced equity round.

1Preferred shares represent ownership in a business and that have a priority claim over common shares in terms of dividends and capital distributions.

Preferred Shares are issued in accordance to regulation update - Ministerial Order No. 117 of 2021
Challenges of using Convertible Notes

To Issuers (Borrowers)

**Future investor interest:**
A business might face challenges when it comes to raising capital for future financing, as potential new investors may be deterred by the existence of loan note investors, as when a conversion takes place, the loan note investors are likely to receive similar rights as the new investors while paying lesser for the equity share.

**Loss of control:**
Investors, i.e., Loan providers, may end up with a majority shareholding interest and thus equivalent or more control than the original founders in terms of share rights coupled with a high interest rate and large discount in the event that shares issued upon conversion exceed those originally held by the issuers. Accordingly, issuers may see it fit to consider separate classes of shares, while expecting negotiations around voting rights and dividend distribution rights.

**Insolvency:**
events of automatic or required repayment may result in default and insolvency of the issuing company and in certain circumstances the personal bankruptcy of the founders where the directors are required to provide personal guarantees as a repayment of the loan.

**Pricing future equity rounds:**
Certain clauses such as the valuation cap and the conversion discount can complicate future equity raises by setting price expectations.

To Noteholders (Lenders / Investors)

**Lack of control:**
Until the actual conversion, Convertible Note holders are often with little to no influence over the company and the trajectory of their investment. Usually, the valuation of a noteholder’s investment will be determined by future Investors who may negotiate a valuation disadvantageous to the noteholder. Specifically, if no valuation cap is placed on Convertible Notes, the issuer and the noteholders may find their interests misaligned regarding the valuation, with Issuers wanting the valuation to be as high as possible, while noteholders wishing for the opposite.

**Tax considerations:**
When investment involves Foreign Investors who are investing from abroad, there may be some tax challenges for them in other jurisdictions (for example with respect to taxes on Capital Gains or Income Tax) that may come into play, as compared to an investment done through shares.
Key terms

**Principal amount:** The financing amount which is being invested by the investor.

**Interest rate:** The parties to agree on interest rate applicable to the debt amount. According to international practices, the interest rate is usually higher than loans obtained from banks. The interest accrues and adds on to the principal invested, thus ultimately increasing the loan value to the investor. This typically results in an increased issued number of shares upon conversion as generally interest applies but does not get paid in cash.

**Price of the equity at the time of conversion:** Investors use the principal amount, interest rate, valuation cap, discount rate and maturity date to evaluate their investment in Convertible Notes and defining its value:

- **Valuation Cap:** Setting a contractual cap or ceiling for early Investors on the valuation of the business upon issuance of shares, represents the maximum price per issued shares that noteholders would pay on conversion. Ultimately, this pre-money valuation will be used to calculate the quantity of shares that the Investors will receive against the value of their Convertible Notes at the time of conversion. In essence, it entitles Convertible Note holders to convert to an equity stake in the business at the lower of the valuation price or valuation cap, in the subsequent financing rounds. They work as a protection mechanism for early Investors and represent a reward for Investors taking a risk by investing at the very early stage.

- **Discount rate:** Since the notes are a form of convertible debt instrument and similar to valuation caps to compensate for the Investor’s risk by investing in the business at such a premature stage, the relevant parties may agree to a discount on the official share issuance price that is provided by the business to the Investor upon conversion of the debt to preferred or common shares. Discount rates typically range between 10% and 30%. Other than the valuation cap, a discount rate is another form of early investor reward mechanism. Noteholders not only end up getting credit for both their original principal plus the accrued interest to determine how many shares they receive at a pre-set valuation cap, but they may also get a discount to the price per share of the new equity.

Conversion provisions and events: Convertible Notes must define the qualifying events that trigger conversion including:

- **Future equity financing and priced equity rounds:** This is when the set target for reaching equity rounds by an agreed amount and an agreed date is achieved by the startup (for example, $10,000 within two (2) years). Future financing conversion provisions attached to the loan notes may also stipulate conversion potential of loan note upon first (seed) share issuance and valuation through a priced equity round. A priced equity round is when the company agrees on its full valuation, negotiates terms of shareholding with the new round of investors and issue new shares to them. This is what is referred to as a Series A round in the startup community. When a priced equity round occurs, outstanding convertible loans will automatically convert at the same or discounted price, such as by applying a valuation cap or a discount rate, both discussed herein.

- **Maturity Date:** the date on which the loan principal and any accumulated interests becomes payable by the company to the investors, if it is not converted into shares or if an event of default occurs. This is typically 12-24 months after the Convertible Note’s issuance date. It is important to note that in the event that a startup is unable to convert its debt by the maturity date, an amendment which either grants an extension or accepts the conversion of the note into shares may be agreed to with the investors. Rational Investors are unlikely to force a startup into bankruptcy or liquidation. On the contrary, such investors usually aid in achieving long-term success in the startup and protect their investment. Rational Investors agree to extend the maturity, or the repayment rights are waived or simply not exercised.

- **Other conversion provisions:** Other than priced equity rounds triggering a conversion of the loan into shares, there will often be default conversion provisions triggered by, for example, a long stop date, and a (usually long) list of breaches, change of control and majority share sale, major asset sale transactions, a public listing event of the company, etc.
Key terms and features

Redemption provisions upon default: Convertible loan notes will often include redemption provisions, where a list of triggers and default events will allow the investor to redeem the loan instead of converting it to shares. Common events of default include failure to repay or convert at a set date, failure to comply with conversion obligations, not achieving requisite level of financing within a set timeframe, material breaches by the company, insolvency or not providing notice on fundamental changes to the investor. Such events will trigger principal and/ or interest settlement to the investor, which will likely cause financial distress to the investment and business. The Convertible Note typically obligates the Startup to repay the payment equal to the outstanding principal and the accrued but unpaid interest if the company is sold prior to the maturity date.

Conversion example: A $10m Convertible Note holder has provisions in place that provides him with a discount rate of 20% or a valuation cap of $50m. If the Startup is later valued at $100m with each share valued at $1.00 (100m shares):
- **Discount Rate:** The Convertible Note holder relying solely on the discount rate provision would have the option to purchase the shares at a 20% discount, or $0.8 for each share (for a $10m investment, holder will receive 12.5m shares instead of 10m shares).
- **Valuation Cap:** If the Convertible Note holder wishes to rely on the valuation cap provision, which is set at $50m, the Convertible Note will convert into equity as if the price had actually been $50m, i.e., we get an effective price of $0.50 per share. This means that Convertible Note holders will get twice as many shares (for a $10m investment, holder will receive 20m shares instead of 10m shares).

Features

**Investors Rights:** Parties may agree to provide the investor with certain rights, such as the right to access information related to the company such as financial statements, preemptive (or pro rata) rights which would allow investors to subscribe for additional shares in the next equity financing, and attending general assembly meetings, without the right to vote.

**Amendments:** Amendments and waivers may be done based on the consent of the startup and the leading investor.

**Terms of Termination:** parties may specify the circumstances under which the investor may terminate the agreement. Upon such termination the startup shall return the debt amount and any agreed interest rate to the investor.

**Repayment Terms:** The parties may agree on repayment terms in the event that a Conversion Event does not occur. This may include, for example, cash repayment, or automatic conversion into equity.

**Option of Partial Payment:** Startups may, prior to the end of the agreed maturity date, provide partial payment of the debt to the investor prior to the end of the agreed term, subject to providing the investor with a thirty (30) day written notice.

**Whether the debt is guaranteed:** The parties may agree to any type of guarantees, such as a bank guarantee, collateral or surety. This is unusual and debts are usually unsecured.

**Regulating utilization of debt:** Terms governing how the debt would be spent by the company.

**Term sheets:** Prior to signing a Convertible Note, Investors will commonly (but not necessarily) request Startups to negotiate and draft a Term Sheet. A Term sheet is a ‘non-binding’ document that lays out the terms and conditions for an investment. Terms sheets allow parties to agree on the key components of the Convertible Notes. Once completed, the parties can draw up the Convertible Note, which conforms to the details of the Term Sheet, among other terms and conditions, as described in this section. Startup companies are encouraged to agree on these terms for purposes pertaining to transparency, as they eliminate most uncertainties and provide the relevant parties with clarity and assurance.

In essence, a Convertible Note is a contract so there is potential to include any terms, and all is negotiable.
Company considerations

The starting point is to review the company’s articles of association and consider if a new class of share needs to be created for any conversion shares. On the basis that there are no changes required to the articles or classes of shares the next steps involve drafting and negotiating the loan note instrument along with the following considerations:

Getting investors’ interest

Prior to proceeding with the formal Convertible Notes process, companies would have to reach out to potential investors after undertaking the relevant due diligence in order to persuade them to provide the debt. Companies, especially startups, would usually prepare a pitch with a slide deck which may include:

- **An overview of the startup/company**, including the relevant business activities, organization structure/personnel, unique value proposition, governance structure, SWOT analysis and risk and related the related mitigants.

- **A financial forecast** which would cover the period before and after receiving the Convertible Note. This would enable investors to have visibility to the plan and vision of how the debt would be utilized and later repaid/converted.

- **Identifying the relevant markets** that the company’s products or services would be entering, the rationale behind it and the opportunities that the company will be able to capitalize upon.

- **Proposed terms with regards to the Convertible Note and its utilization** (please see ‘Key Terms and Features’ section on key matters to be agreed between the investor and the startup).

- **Identifying any material non-public information** to investors.

Legal and regulatory requirements

Startups and companies must ensure compliance with relevant laws and regulations, which vary from one jurisdiction to another. The following legal provisions govern the process for issuance of Convertible Notes in the Kingdom of Bahrain:

**Article 239bis of CCL amending the Commercial Companies Law promulgated by Decree No. 21 of 2001 in the Kingdom of Bahrain (‘the Law’)**:

Allows closed joint stock companies that are not licensed by the Central Bank of Bahrain (‘CBB’) to borrow money from investors with the aim of increasing share capital by way of issuing loan notes that are convertible into company shares ‘Convertible Notes’, subject to:

- approval of the extraordinary general assembly; and
- provisions of the company’s articles of association.

**Article 81 of the Central Bank of Bahrain and Financial Institutions Law requires, for the purpose of offering the notes**:

Compliance with the CBB regulations concerning issuance of securities as outlined in the Offering of Securities (‘OFS’) Module of the Rulebook 6, which include the following (unless specially exempted):

- Submitting all relevant information, declarations and attachments (such as an offering document and draft instrument);
- Confirming compliance with the Bahrain Corporate Governance Code;
- Meeting the other CBB requirements for the type of offering (including public, rights offering, private placement etc);
The process of issuing Convertible Notes

Regulation No. 118 of 2021 with respect to the conditions and regulations of issuing Convertible Notes by closed joint stock companies (‘the Regulation’)

The Regulation outlines:
- Scope of applicability: Convertible Notes issued by closed joint stock companies that are not licensed by the CBB.
- The process to be followed by companies that intend to issue Convertible Notes (please refer to ‘Regulatory Requirements for Application’ Section).
- Subject to the provisions of Article (140) of the law, the company may not issue convertible debt securities until after the issued capital has been fully paid.
- The instrument must stipulate whether interest is accrued, indicating the percentage.
- Conversion of the loan principal and accrued interest into ordinary shares by virtue of the Convertible Note shall be in accordance to the terms, conditions and rules agreed between the company and note holder(s) in a separate agreement, with no specific stipulations set forth by the directive, provided that no restrictions are set in accordance with the provisions of the law regarding the ownership of shares in commercial companies. The agreement would be referred to in the convertible debt instrument and is considered an integral part of it.
- The company shall keep a register called the “Transferable Debt Securities Register” in which all data relating to the convertible debt securities issued by it and all changes that occur to its data shall be entered, and access to it shall be available to all shareholders of the company.
- That the debt must be converted to equity within a period that does not exceed five (5) years from date of issuance, otherwise the company shall pay the value of the loan and the related interest - if any - within thirty days of the note holder’s request.
- Upon liquidation or bankruptcy of the company before converting convertible debt securities into shares in the company. The rights of the note holder relating to the debt principal and any accrued interests shall precedence the rights of the existing shareholders in the company.
- The Regulation leaves it to the parties to agree upon:
  - The manner by which the loan amount is to be disbursed, including any special restrictions that may be factored in.
  - The cases and circumstances upon which the note holder may terminate the agreement, obligating the company to settle the loan plus accrued principal amount.
  - The note holders’ rights to any data or information related to the company, as well as their rights to attending ordinary and extraordinary general assembly meetings and participating in the deliberations without having the right to vote.
  - The company valuation cap and/or discounts as well as other privileges, special conditions, incentives conditions, and triggers relating to future loan conversion rounds.
  - Any guarantees or warranties attached to the borrowing.
  - Future Convertible Note subscription priorities, without prejudice to the provisions of Article (150) of the law.
  - Loan conversion or repayment timeframes, provided the company informs the note holder thirty days in advance of its intention to settle the amount of loan and accrued interest in cash (please refer to the 5-year conversion deadline previously mentioned).

Regulatory Requirements for Application

Article 239bis of CCL requires companies to:
- Obtain the approval of the extraordinary general assembly, and
- Send a written notification to the Companies’ Control Directorate in the Ministry of Industry, Commerce and Tourism (‘the Department’), which contains the following:
  - Intention to borrow by issuing notes convertible into shares.
  - The overall value of the debt intended to be borrowed from the investor.
  - Key data with respect to the Convertible Note.
  - Accounting report on the company showing its financial status.
  - The report would include the company’s business activities and the feasibility of borrowing by issuing Convertible Notes.
- The Department may, from time to time, request any other additional information including but not limited to updates on the issuance of the Convertible Note.

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2 Regulation only applicable to entities and companies not regulated by the Central Bank of Bahrain.
Over the past decade, alternative solutions such as Simple Agreement for Future Equity (‘SAFE’), and the Keep It Simple Security (‘KISS’) were developed to replace Convertible Notes as the financing instrument of choice when funding startups\(^4\), notably in the US but also in some other jurisdictions. The key purpose was to have clear templates and avoid extensive agreement negotiations with investors, thereby allowing startups to obtain financing in a shorter period of time at lower costs.

**SAFE similarities with Convertible Notes**
SAFE share certain features with Convertible Notes, such as:
- Converting into equity if certain agreed conditions, such as conversion events, occur.
- Conversion prices are set.
- Investors have the priority in the event of insolvency.

**SAFE, KISS and Convertible Notes differences**
Unlike Convertible Notes, SAFE and KISS do not have a maturity date and do not accrue interest. In essence, the SAFE is a Convertible Note that has had its debt-like features stripped away.

SAFE and KISS can be best conceptualized as contracts by which an investor commits capital to the business today in exchange for the right to receive shares in the company if certain contractual conditions are met in the future.

**SAFE and KISS differences**
While SAFE and KISS appear identical, there are some subtle differences. On one hand, SAFE will automatically convert into equity when the startup raises money from investors in a funding round in exchange for shares. On the other hand, KISS will only convert when the company raises a set amount, most commonly at least $1 million in a funding round in exchange for shares.

\(^4\)SAFE was developed by Y Combinator, while KISS was developed by 500 Startups (both are startup incubators).
Convertible Notes - Exploring alternative investments
Any company wishing to issue Convertible Notes in Bahrain should obtain independent advice considering its appropriateness with regard to their respective objectives, financial situation and investment needs. If you are in doubt about any aspect of this document and/or the CCL, you should consult a professional adviser.
KPMG has had a presence in the kingdom of Bahrain over 50 years. From a small local accounting firm, founded in 1968 by university friends Jassim M. Fakhro and Hussain Kasim, KPMG in Bahrain has become one of the largest and most prestigious professional services firms in the country.

KPMG in Bahrain employs over 300 professional staff and partners. We provide clients a suite of locally-supported Audit, Tax and Advisory services. We recruit the best and brightest from around the world.

We currently have 19 nationalities working across our teams, but we also draw on local talent.

Bahrainis represent over 60% of our total workforce and hold many of our senior leadership positions. This enables us to combine the strength of KPMG’s considerable global capabilities with local professionals, deeply aware of the opportunities and challenges relevant to Bahrain.

We believe our commitment to investing in local talent is not just good for KPMG, it is good for the community. We work closely with universities across Bahrain to employ many local interns and graduates.

Our commitment to their development includes financing their endeavors in higher education, ensuring they receive ongoing technical training and experience and providing overseas opportunities.

KPMG alumni are in leadership positions at many local government and private sector organizations. The skills and experience, which our people acquire at KPMG, are helping drive Bahrain’s economy and ensure the country’s future. When choosing to work with KPMG in Bahrain, clients are choosing to work with a firm with rich local history and deep community connections.
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