Ehata

Ehata Financial Company

Global Markets Advisory & Beyond

Ehata Financial Yearbook

TABLE OF CONTENTS

Ehata Financial in Numbers 01
Theme Review of 2020 02
Hedge Restructuring Theme 03
PPPs and Hedge Strategy Theme 05
Hedge Accounting Theme 07
Our Partners that we have Proudly Served 09
Looking Ahead 10

EHATA FINANCIAL in numbers

20 Yr

More than 20 years of project finance duration exposure

SAR **25** bn

totaling over SAR25bn notional of advisory mandates

SAR **4** bn

SAR 4bn of Hedge Accounting work

100%

%100 Saudi talents working within our core advisory service

Theme Review of **2020**

A YEAR OF EXTREME VOLATILITY AND UNPRECEDENTED BUSINESS TRANSFORMATION

2020 has been an extraordinary year that pushed us all into adapting as the pandemic shocked the global economy. We witnessed the drastic toll of the pandemic on economic activity, leading to historic job losses; crude oil prices dipping below zero for the first time ever; fiscal and monetary policy makers paranoidly stepping in to help the damaged economies recover; global markets volatilities skyrocketing and OTC hedge providers' trading risk appetite narrowing.

There are more metrics that can put the severity of the pandemic into context. However, the pandemic has left the global ecosystem considerably impacted . Nonetheless , just like any other crisis, we have all learned a lesson.

At Ehata Financial, we are proud that we have successfully partnered with leading local institutions to help them navigate the financial risk aspects through such a difficult time. We have intensely worked on hedge restructuring mandates. Ehata's client base in this segment alone ranged from publicly listed firms to family businesses and large conglomerates.

We have pledged our resources to assist such an emerging need, with the understanding that every institution has different objectives that need to be aligned with the overall strategy. The other significant theme is the rise of the public-private partnership (PPP) projects. We have seen an accelerating push by the government to embrace privatization in its few forms, including PPPs and full/partial asset sales.

Ehata has worked on key PPP projects within the kingdom to address the hedge strategy aspects and the associated typical long-term exposure.

As financial risk advisors, we noticed a rising need for hedge accounting. This is unsurprising when hedging instruments fair values deteriorate and hedged notional increase as corporate treasurers seek to lock-in low rates. In this report , we will also demonstrate our hedge accounting work and walk through a case study for better elaboration.

At Ehata Financial, we are proud that we have successfully partnered with leading local institutions to help them navigate the market risk aspects through such a difficult time.

Faisal Al Jasir
Co-Managing Partner

Hedge Restructuring

YEAR 2020 MARKED A SIGNIFICANT YEAR OF HEDGE RESTRUCTURING AND RETHINKING THE MARKET RISK STRATEGY FOR OUR CLIENTS

In the wake of 2020's unprecedented volatility, we have noticed many local corporations restructuring existing hedging instruments. We worked with large corporates to help them avoid some common traps when undertaking such a critical step.

We have observed that when market volatility kicks-in, corporates reap the benefits of suitable hedging. But this is impossible without an adequate, enterprise-wide hedging policy or a detailed guideline around managing market risks. We should all remember that any hedge's ultimate objective is not to make money but instead protect the business from relevant market risks.

When COVID19- hit, we noticed that many corporates found themselves rethinking their strategy and business continuity. A hot topic was debt restructuring. Many debt-linked hedges took place amid the low interest rate environment. We have observed some “Blend and Extend” hedges, where new hedges are topping up and extending old ones, offering a liquidity boost, and achieving lower hedge rates.

But it is the restructuring of exotic or complicated derivatives that poses a significant threat to any corporation. The minute the company realizes that its hedge no longer fits its business requirements, or if the hedge has completely lost its appeal on the back of a sudden market move, it must undertake a thorough and careful diagnostic work.

This step helped us demonstrating the optimal required risk management strategy. Typically, financial institution that sold the transaction in the first place might be tempted to restructure such trade and help its client. Information asymmetry between the derivative user “a company” and the hedge provider “a financial institution" creates a knowledge gap that could lead to unfortunate outcomes that we have observed, such as:

- Opaque and non-transparent pricing of exotic derivative trades.

- A pricing complexity that tempts hedge providers to make income margins beyond commercially reasonable standards.

- A lack of a proper risk demonstration & explanation due to the hedge provider inclination to sell its products.

Before implementing any restructuring, we tend to advise our clients to address specific areas to identify the objectives. When deciding on a restructuring strategy, we often find that corporates prioritize some shortlisting criteria (e.g, liquidity aspects, accounting eligibility, fair value volatility, treasury limits utilization, etc.).

While some focus on increasing certainty around future cash flows, others aim to limit any further deterioration in the Mark-to-Market (MTM) value of the derivatives trade.

CASE STUDY

BESPOKE INTEREST RATE DERIVATIVES PORTFOLIO RESTRUCTURING

USD & SAR
Multi-Currency Exposure

100%
Neutralized risk post execution

Background

- A leading Saudi- based company. The company has entered into more than one leveraged interest rate derivative structure with significant negative mark to market (MTM) position that was the result of a material change in the interest rate environment and , hence , the risk profile.

- The aim of the company 's management was to understand the current risk profile of the existing trades . The company had to choose between terminating the positions with a significant breakage cost or restructure the trades by extending their maturities.

- Hedge providers shared significant number of restructuring solutions and management was focusing on independently verify the most efficient and informed decision via hiring an experienced and independent third party.

Our Approach

- Ehata was hired to assess the situation. Our role at the pre-hedge restructuring stage was to clearly demonstrate the risk arising from the structured rate derivative portfolio and to evaluate the available alternatives. Once the recommendation was agreed, the portfolio was neutralized after a successful hedge execution with two major banks.

- The mandate team carried out a thorough documentation review and produced an integrated assessment of the overall exposure, including portfolio risk breakdown /sensitivities to the most basic derivative component.

- The client was able to make an informed decision after being able to clearly visualize the risk and the potential risk exposure along with applying stressing tools to gain more insights.

Outcome

- Ehata has successfully coordinated two separate hedge executions with two major banks, who were parties on the original trades. Prior to execution, a series of dry-run exercises ensured pricing alignment among all stakeholders.

- The outcome has not only provided the company with a tangible execution cost saving, but also a timely execution that safeguarded it from being exposed to further market risk volatility and severe MTM deterioration.

- Ehata has also demonstrated the importance of having an internal governance framework and hedging policy to guide future hedging decisions and avoid falling in the trap of a subjective decision making.

PPPs AND HEDGE STRATEGY THEME

DESPITE THE UNPRECEDENTED CHALLENGES, PROGRESS IN PRIVATIZATION INITIATIVES AND PROJECTS, NAMELY PPPS, HAVE CONTINUED ACROSS ALL SECTORS

During 2020, despite the unprecedented impact of COVID-19, we have observed an accelerating push by the government to embrace privatization in its few forms, including PPPs and full/partial asset sales. Awarding have been seen across water, education, and municipalities related projects, among others.

Furthermore, we have witnessed the completion of the first batch of the flour milling sector privatization through a full divestment to qualified strategic investors. Last year also have indicated an encouraging appetite by financial institutions to fund such strategic infrastructure projects despite the challenges.

This has been noticed by the provision of long-dated funding required in these projects by some commercial banks at relatively competitive margins. For such projects, the debt element typically constitutes most of the investment value with duration spanning more than fifteen years.

Regardless of the privatized sector under consideration, interest rate exposure has a common set of risks that we believe have been delicately considered by some of the local procuring authorities request for proposals (RFP) and their requirement for a hedging strategy.

On the other hand, the relevant challenges we observed locally (at the bidding stage) has been still the need to construct a robust methodology for interest rate assumptions beyond the Saudi Riyal liquid curve. More importantly, objectively identifying the minimum reasonable hedge ratio, and the optimal hedge duration were areas overlooked by some of the participating bidders.

We expect PPP projects to grow in 2021 and to further expand into different sectors such as healthcare. We believe that this growth, from the private sector perspective, will create a need for more information and guidance around managing financial risks.

Hence, it comes as no surprise to witness an increasing hedging activity among our corporate clients to reap the benefits of low interest rates and enhance certainty around future cash flows under a floating rate borrowing arrangement. Some have opted to explore a "Blend-and-Extend" strategy to reduce the liquidity burden under existing hedges.

Managing balance sheet interest rate and liquidity risk was a particular concern amongst some of the non-bank lenders. We typically address these risks by bridging the missing link in the existing and relevant policies, while establishing the governance framework around limits and triggers keeping an entity risk appetite and overall financial objectives into consideration.

We expect the volume of hedging transactions to increase in 2021 given the projected low interest rates outlook as well as the persistent volatilities in the currency market.

We believe that the unpredictability encountered in the year 2020 has reinforced the case for investing in risk management processes and proper hedging practices.

CASE STUDY

PPP / HOUSING PROJECT

SAR 1bn
Interest Rate Exposure

20+ Years
Financing Duration

Background

- A SAR ~1bn project to occupy an area of more than 500,000 square meters and accommodate the housing requirements for over 2,000 employees working for a gas plant in the Eastern Province, Saudi Arabia.

- The financing documentation had a %95 mandatory hedge ratio for the first five years.

- Ehata's role was to assist the project company (the bidding consortium) on the profit rate hedging related to the project, help create a satisfactory execution script, benchmark the dry-run pricing for the required hedging and manage the market execution . Along the way , we kept very close communication with the bank and every dry run pricing was broken down into its components to ensure price transparency and smooth execution.

Our Approach

- We first defined a hedging protocol to deliver a smooth, fair and transparent execution roadmap to all parties involved.

- To enhance transparency and fair dealing, we ensured a competitive execution procedure was adhered to and that pricing reflected fair market rates and were in line with the agreed benchmarking protocol.

- Due to the high sensitivity of the project's KPIs to profit rates, we secured a certain notional deviation range and time buffer for the project company and utilized the financial model to measure the impact of market rates on the project's targeted KPIs. Furthermore, we made sure the project company had the advantage of quantifying the market rates impact in advance, which in turn enhanced the project company ability to optimize the debt profile.

Outcome

- We along with the project team coordinated a timely execution process and conducted a series of dry-runs exercises to provide transparency to the parties involved, and ensure close attention is paid to the pre-agreed hedge protocol.

- We were able to eliminate any undisclosed margins and lower the hedge margins and achieving significant saving versus the initial pricing the project received, that was reached through benchmarking each of the dry-run outcomes with our internal models and market references.

- We along with the project team ensured that all documentation is executed in a timely manner, hence, the project company saved time, money and resources.

HEDGE ACCOUNTING THEME

THE PANDEMIC PUSHED CORPORATES TO SHIFT THEIR ATTENTION INTO THE ACCOUNTING IMPLICATIONS OF DERIVATIVES TRADING

The pandemic trailed various wounds, of which accounting implications was among the most hurtful. We noticed a rising demand for hedge accounting support in 2020. This is unsurprising when hedging instruments' fair values deteriorate and hedged notional increase as corporate treasurers seek to lock-in low rates.

According to the Bank for International Settlements (BIS) Over the Counter (OTC) derivatives statistics report, the gross market value of OTC derivatives surged by 33% in the first half of 2020. Unsurprisingly, 40% of the increase was attributed to interest rate derivatives. In particular, USD-denominated contracts gross market value rose 86%, the largest since the Global Financial Crisis (GFC) in 2007-2008.

At Ehata, we have assisted many of our clients overcome their hedge accounting challenges. The pandemic's impact on derivatives fair value led to abnormal revaluation losses. Those fair value losses were previously impacting our clients Profit and Loss statement.

However, as the hedge accounting treatment was set-up, we succeeded in sparing our clients' P&L the unsatisfactory hedge revaluation swings. Unfortunately, we noticed a decent lack of awareness around the International Financial Reporting Standards (IFRS) requirements for a derivative instrument to qualify for hedge accounting. As most of corporates' derivatives dealings are handled by the corporate's treasury department, some missed the proper accounting implications consideration.

Some trades embedded cheapening features and were designed to hedge the corporate portfolio exposure. Although some made sense both commercially and economically, they often overlooked the accounting aspect.

As global economic activity slowed down amid the pandemic, various forecasted and assumed hedged items were cancelled, postponed, or even commercially revised.

Hence, led to a mismatch between the hedging instruments and their associated hedged items. We reaffirmed the importance of the bridge linking treasury dealing to a smooth accounting implication. The hedge decision makers' understanding of accounting implications is crucial in making a smooth handover to accounting.

At Ehata, we expanded our hedge accounting engagements to include a "Pre-Setup" phase, a phase where we helped our clients utilize the prevailing market levels in redesigning and re-balancing their hedges to an optimal accounting manner. For 2021, we expect the demand for hedge accounting to remain high.

Entities recovery from the pandemic is still ongoing and, in some cases, expected to last for a few years. Many of our clients are enlarging their hedge national's due to their narrowed risk appetite over the short run (the recovery era). The sizable hedged notional will materialize derivatives fair value swings relative to a recovering P&L statement. Hence, emerging the rising need for hedge accounting.

CASE STUDY

HEDGE ACCOUNTING:
MULTI-ENTITY GROUP DERIVATIVES PORTFOLIO

USD & SAR
Multi-Currency Hedges

10+
Hedging Instruments

Background

- A multi-entity Saudi-based industrial group has a centralized treasury function that oversees hedging activities for the parent company and its subsidiaries.
- The group was concerned with the volatility in the fair value of its outstanding multi-currency interest rate hedging portfolio of over SAR 1,000,000,000.
- The group hired Ehata to apply cash flow hedge accounting, hence, spare fair value swings in Other Comprehensive Income (OCI) statement.

Our Approach

- At the outset, Ehata's approach was to identify the qualifying hedging instruments.
- The mandate team would then analyze if non-qualifying instruments could be amended to meet IFRS9 requirements or if they were intentionally disqualified due to their immateriality.
- Upon completing the first two steps, the cash flow hedge accounting started with the 'Set-up' Phase, which includes the full spectrum of required support, that ranges from drafting the hedge designations and measuring of ineffectiveness, to the support we offer in quantifying the effect of credit risk and preparing of accounting journal entries.
- Ehata successfully negotiated the full hedge accounting spectrum with the company 's auditors and granted the company a flexible and repeatable hedge accounting exercise that fairly represents the group's hedging activities in financial statements without penalizing its P&L statement with fair value swings

Outcome

- We negotiated the terms of cash flow hedge accounting designations with the company's external auditors. The aim was to ensure they provide the group's Treasury with the flexibility possible in future amendments to hedging instruments without jeopardizing the cash flow hedge accounting relationship.
- The hedging instruments were held at a group level, while underlying loans are scattered among the group's entities. We supported the group in the required intercompany mapping of hedged items and hedging instruments at parent and subsidiary levels. We conducted effectiveness testing using best practices while maintaining a transparent methodology.
- Ehata also prepared the yearend financial statements notes as per IFRS7, highlighting the instruments ranking on IFRS fair value hierarchy, financial performance sensitivity to interest rates, and the impact of hedging instruments on liquidity.

WE HAVE PROUDLY SERVED

Abunayyan Holding

McDonalds Saudi Arabia

Saudi Aramco

Mohammed Ali Al Swailem Group

Nadec

Al Muhaidib

Arabian Petroleum Supply Company

Dur Hospitality

SALIC

Al Khorayef Group

Mohammed I. Alsubeaei & Sons Investment Co.

Orascom Construction

Zamil Real Estate

Al Nahla Group

Saudi Finance Company

Looking Ahead...

LESSONS LEARNED FROM THE PANDEMIC CRISIS AND OUR COMMITMENT TO YOU

The COVID-19 pandemic will shape financial risk management in a way that few other events have. Many businesses have faced and still are facing the challenges of operating a business through an unprecedented shutdown. None of us could have foreseen the scenarios we have faced together . As we move ahead , we believe analyzing multiple potential scenarios that consider the interrelations between various macro /micro risk factors , diminished diversification of exposures , and hidden risk concentrations are among the many approaches necessary to start mitigating financial risks in 2021.

To be better equipped this year, we anticipate more organizations to rely on their established risk management framework as a starting point in confronting financial risks. Moreover, within the domain of public companies , we have noticed that senior management and experienced board members have played a central role in the risk management process . A trend we believe is of utmost importance and expect would continue this year.

At Ehata Financial, we believe it is always a good time to consider your financial risk and we fully understand that every institution has unique exposure, so there is no one-size-fits all solution when it comes to hedging. Therefore, it is part of our mission to continue and support you in the areas we confidently can add value and believe is most crucial. Locally, we expect further acceleration in adopting the IFRS 9 standard.

We aim to maintain engaging our clients in the areas of financial derivatives valuations, hedge accounting, and expected credit losses provisioning. Ehata hedge accounting portfolio have increased significantly last year, where we have provided our services on more projects than in any previous year.

In 2021 , what we know for sure is that we highly value your business . We aim to relentlessly continue delivering a meaningful financial risk management process that is tailored for you . We are immensely proud of playing a part in your financial risk management plans . We look forward to supporting many more throughout this year and into the future.

At Ehata Financial, we believe it is always a good time to consider your financial risk and we fully understand that every institution has unique exposure

Muadh Alhusaini
Co-Managing Partner

DISCLAIMER

Ehata Financial Company is authorized and regulated by the Capital Market Authority (license no. 20-17183). Ehata Financial Company may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Rd, Avenue Building, 5th Floor, PO BOX 241106, Riyadh 11322

The information contained in this report was prepared by Ehata Financial Company. Though the information herein is believed to be reliable, Ehata Financial Company makes no representation as to its accuracy or completeness. Under no circumstances shall we or any of our associates or any of our or our associates' respective directors, officers, employees or agents, be liable to the Client for indirect or consequential losses including any failure to realize any profit, advantage or opportunity relating to the transaction or otherwise.

The information contained in this report should not be distributed beyond the intended recipients and should not to be reproduced in any form without the express consent of Ehata Financial Company. This presentation may have been supplemented by additional information discussed during any meetings, phone calls or oral presentation (s) between us, and this should be taken into consideration when reviewing this presentation. If you require any information, explanations, or specific advice, please contact us, and we will be happy to discuss this with you.

www.ehata.com.sa