Ehata
Ehata Financial Company

Global Markets Advisory & Beyond

EHATA FINANCIAL YEARBOOK

2021

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EHATA IN NUMBERS

highlights for

2021

More than

SAR 23B

of Market Risk Exposure

SAR 7B

of Hedge Accounting Work

More than

SAR 3B

of PPP Exposure

10 Industries

were covered across different market risk exposure

INTRODUCTION

MUADH **ALHUSAINI**
Partner

We are immensely pleased to share with you our Yearbook for 2021. During the past year, we witnessed unforgettable economic developments. And it marked our fourth anniversary here at Ehata Financial, filled with enriching learning experiences and fruitful engagements with our clients.

One thing we enjoyed for sure was the unprecedented local economic development. As you may have noticed, Ehata was around to provide thought leadership in the local market through monthly bulletins, webinars, special reports, and papers. We proudly participated in landmark projects and translated our wealth of niche market risk management knowledge into tangible solutions.

We were also delighted to see the local market's maturity driving risk management and hedging awareness. Consistent dialog with our clients and their generous feedback proved we have many more avenues to explore together, and our exciting journey never ends.

In 2021, we had the pleasure of providing advisory services to publicly listed firms, government entities, and privately held institutions across a wide range of unique projects.

No two projects were the same, whether it be hedging policy, hedge execution, dispute resolution, Public-Private Partnership (PPP) transaction, or hedge accounting support. Communicating closely with our clients inspires us always to analyze, design, and recommend the optimal solution while paying undivided attention to every detail.

In this Yearbook, we will briefly walk you through some of the key themes we saw emerging last year. For example, the PPP landscape is thriving, and many projects are accelerating. This presented an opportunity for Ehata Financial to leverage its core knowledge to advise on market risk and hedging, which covered the bidders of these projects and the procuring authorities.

Thank you to every client who joined us in this journey – we always value and welcome our collaboration. As we say to our clients, we are an extension of your company's team, and you will always find us close when you need us. Our journey would have been impossible without the commitment and professionalism of Ehata's team members, who consistently take pride in serving every client.

Our clients' satisfaction and genuine support have pushed us far beyond what we expected to achieve in 2021, raising the bar to accomplish more this year. We are thrilled to see how 2022 is already shaping up and eager to score more successes with our clients and partners.

I hope you enjoy this Yearbook. As always, we welcome your valuable feedback as we thrive on being your chosen financial risk management partners.

Navigating The Pandemic Implications & Optimizing the Hedge Governance

ABDULLAH **ALALI**
Associate Director

We noticed the year 2021 had a widespread reflection spirit. As the pandemic's consequences elapsed, corporates shifted their focus to understanding the lessons learned and enforcing them as they continued navigating their growth opportunities in the post-pandemic era.

Throughout the year, we were often approached to help our clients restructure their derivatives portfolio to align it with the new underlying shape, dispute the sale of non-suitable structured derivates by hedge counterparties, identify the gaps in their current financial risk management approach, and draw a roadmap for optimal risk governance framework going forward.

As some derivatives fair values exploded following the pandemic, some clients, focus was primarily on re-exploring their deal closure process and pinpointing the loopholes in their derivatives structures qualification criteria. Walking through various entities› deal closure process, we noticed that differentiating between hedging and speculation in structured derivatives is not as easy as textbooks suggest. Corporates are often persuaded into 'profitability' traps, which is mainly the result of untransparent hedge provider disclosures and/or the lack of internal governance procedures. Last year, we took pride in leading our clients' technical disputes facing hedge providers' executive management team and negotiating a resolution plan for mis-sold products.

Similarly, we noticed among the pandemic's consequences a high influence on the Board of Directors' perception of financial risk management cruciality. Thus, we have seen an exceptional demand for policies and procedures gap analysis and risk management framework establishment. We proudly helped our clients define their risk management objective, risk quantification measures, derivative product selection criteria, benchmarking and execution management, and ongoing risk monitoring and reporting.

Defining the roots of previous problems is good and reflecting the lessons learned in ongoing operations is great. But there is a statue beyond great!

We have seen clients learning from others' mistakes, and such entities had no bad experiences to learn from but rather took a proactive approach to avoid learning things the painful way.

In an environment of persistently escalating inflation, high economic growth potential, and an anticipated change in monetary policy, a changing yield curve structure is widely predicted. Furthermore, we expect the disparity in major economies' recovery pace to fuel FX volatilities. Looking at how major currencies and treasury yields moved during 2021, you would be forgiven to worry about what 2022 has to offer. As always, we advise against allowing only the market outlook to dictate your hedging programs, and we recommend you avoid waiting for the market to tell you what needs to be done. Adopt a proactive risk management approach and make your business targets achievement a priority.

CASE STUDY

HEDGE RESTRUCTURING & DISPUTE RESOLUTION

BACKGROUND

- A leading Saudi-based company. The company has entered into more than one interest rate derivative structure with hedge providers.
- The unprecedented interest rate changes led the hedge portfolio to be deeply out-of-the-money, recording significant negative MTM valuation.
- Ehata was hired to fulfill two key tasks. The first is to analyze the hedge and the potential restructuring strategies. The second is to investigate the suitability and appropriateness of the sold products.

OUR APPROACH

- Ehata kicked off the mandate by immediately attending to analyzing the outstanding derivative trades for potential restructuring to normalize the company's risk profile.
- After finalizing the analysis and recommendation, Ehata conducted a series of workshops with management and board members on the recommended approach, which entails unwinding the existing trades.
- Due to the limited liquidity at the time, Ehata team managed to support the dialog with the hedge providers to offer the needed funding to unwind the trades.
- The approval was obtained in a timely manner, and Ehata conducted a transparent hedge execution process, thus ensuring complete fairness and market pricing.
- Post normalizing the risk profile and unwinding the trades, Phase II of the project began by fully assessing the potential gaps and misselling activities between the hedge provider and our client.
- Ehata found core elements confirming an emblement of misrepresentation to the derivatives transaction. A detailed technical report was issued to the client.
- The report was discussed with all relevant stakeholders, including the client, hedge provider's senior staff, and the legal counsel.

OUTCOME

- The outcome has provided a tangible execution cost-saving and a timely execution that safeguarded it from being exposed to further market risk volatility and severe MTM deterioration.
- The suitability and technical report assisted the client in negotiating better funding terms with the hedge providers, thus improving the creditworthiness and the debt cost structure of the existing financing.
- Our client's staff became better capable of breaking down a derivative structure building blocks to ultimately reach better underlying exposure alignment.

CASE STUDY

ESTABLISHING A HEDGING POLICY

BACKGROUND

- Our publicly listed client was exposed to the risk of rising interest rates via its floating rate SAR borrowing portfolio that is continuously growing as our client expands operations.
- Given the portfolio's growth, the management sought to hold a better grip on financial risk management through (i) analyzing the current exposure, (ii) formulating an interest rate hedging policy to determine the parameters, controls, and KPIs, and (iii) making its staff self-sufficient in managing the growing interest rate risk exposure.
- The company was also interested in implementing an accounting-friendly hedging solution to avoid P&L statement variability.

OUR APPROACH

- Ehata's approach was to conduct an in-depth analysis of the existing portfolio before formulating any hedging strategy. Ehata has kept close communication during such a critical step.
- The mandate team has evaluated current hedging instruments and the potential risk management approaches to manage the interest rate risk.
- We stressed the financial statement's resilience to withstand interest rate shocks as we assess if our client needs to hedge.
- The demonstration included the impact of various hedging strategies on management KPIs.
- To understand the impact on financial statements, we demonstrated (via Monte-Carlo and bootstrap historical simulations) the navigated hedging strategies› fair value paths and potential breakage costs.
- To formulate the hedging policy, the team conducted rounds of discussions across different divisions within the company.
- Ehata documented the governance framework's design and assisted the client in arriving at the KPIs, as per the best industry practices and looking at global peers.
- We conducted various training sessions to equip our client's senior and junior staff with the necessary means to manage interest rate risk.

OUTCOME

- We found that our client had enough headroom to withstand interest rate shocks but could adopt a discretionary hedge to reduce cashflow variability.
- The company became independent in risk identification, quantification, and management. Ehata ensured the transfer of knowledge and working models to the client.
- The hedging protocols were fully established to assist the client in negotiating fair and transparent future hedges with hedge providers. Moreover, the client approved a documented hedging policy to guide, monitor, and audit future hedging actions.
- Ehata successfully showed the importance of having an internal governance framework and hedging policy to guide future hedging decisions and avoid falling into the trap of subjective decision making.

THE ACCELERATION OF THE PPP PROJECTS

ADITYA **BAIJAL**
Associate Director

Appraising the year 2021, the key trend we notice is the recovery from the pandemic shock in economies globally. A push towards revival was evident in the Kingdom as well, which has adopted policies to strengthen the economy. Saudi Arabia leads the way in the region by undertaking a variety of enterprises pertaining to private sector investments, primarily through acquisitions (either partial or full) and public-private partnerships (PPPs).

Saudi Arabia has launched revolutionary programs in alliance with private partners, be it in the healthcare sector, renewable energy sector, or transportation Sector. The Kingdom also announced the Saudi Green Initiate, which along with aim of combatting climate change and promoting renewable energy, is intended to reduce the dependency on oil.

Here at Ehata, we always stand ready with our unwavering devotion to serving our client's financial risk management needs. We understand the importance of risk management in treasuries and the duty the clients entrust upon us to perform. We hold ourselves to stringent standards and keep ourselves prepared with the latest market standards. Several PPP entities engaged with us last year for our interest rate and foreign exchange risk management and hedge advisory services. For all our undertakings, we noted and assessed the risks to the client›s earnings and computed, optimized, and provided sound hedge recommendations that protected the client's exposure from the fluctuations in the financial markets.

We welcome the rise in awareness we observed among our clients regarding the significance of being in sync with the market forces and acknowledging the risks present. We notice clients with no directive to establish a hedge policy actively seeking us out for our services.

Another rising trend brought on by the pandemic was of portfolios with interest rate exposures no longer being served by their hedges. In many cases, the COVID pandemic has led to delays and disruptions in project timelines and loan drawdowns. Hedge reprofiling comes with its own set of challenges – identifying the consequences to internal policy, managing the slippage costs, and realigning with the accounting treatment. For all such cases, we have successfully aided our clients in the reprofiling of their hedges.

We benefit from our unique position in the Kingdom as financial risk management advisors and the experience gained from our work and continue to offer structured and customized solutions for our clients that are in line with their KPIs and policies. Each case goes through a detailed analysis phase, and the hedge, with all its elements, is tailored to the clients' corporate objectives and risk management goals. Having been assisting clients with their risk management needs for some time now, we are privileged to be recognized as leaders in our discipline in the Kingdom, and we strive towards sustaining the momentum we have created.

CASE STUDY

HEDGE REPROFILING

BACKGROUND

- A holding company acting in the capacity of an offtake purchaser awarded a special purpose vehicle to implement a key infrastructure project.
- The SPV has executed interest rate hedge instruments in an agreement with two local banks to protect the underlying exposures.
- Due to the pandemic, the project was delayed, and the consequence was a mismatch between the hedging instruments (with a combined value of more than SAR 500 million) and the underlying exposure, which necessitated a hedge reprofiling.

OUR APPROACH

- The offtaker enlisted Ehata to analyze the underlying exposure drawdown and distinctions of the hedge instruments employed.
- The mandate also included the fair valuation of the new hedge instruments and the prevention of any slippage costs.
- The mandate team optimized the existing hedge protocol, aligning it with best industry practices to ensure fairness and objectivity upon hedge reprofiling implementation.
- Our extensive analysis helped our client identify and employ the new hedges through comprehensive collaboration and price benchmarking exercises.

OUTCOME

- Ehata accurately quantified the mismatch with the current hedge profile and demonstrated notable savings through the extensive collaboration with the various stakeholders.
- We established thorough transparency by providing the best pricing for the new hedge instruments by employing market standard valuation techniques and unveiling any undisclosed margins in the benchmark pricing.
- We provided our client with the requisite market information and substantial supervision assistance with the hedge execution process, including official dry runs and adherence to the hedge protocol.

CASE STUDY

INTEREST RATE HEDGE ADVICE

BACKGROUND

- A Saudi-based company with sponsors located locally and within the GCC region won the bid for a PPP project. The project company has sourced the financing (upwards of SAR 1 billion) via senior debt and Equity Bridge Loans from various local banks.
- According to the agreements with the banks, the project company had absolute discretion on the hedging strategy, including whether or not to enter into a hedge.
- As is typical for any project finance transaction, there were banks› KPIs (such as DSCR) and management KPIs (such as equity IRR) to keep under consideration.

OUR APPROACH

- Our role was to assist the project company with assessing interest rate exposure and recommend an optimal hedge strategy. Additionally, Ehata would also provide hedge execution assistance to the client.
- We produced a strategy paper that detailed the hedging approach aligned with the project company's financial objectives. We engaged extensively with the client to discuss the analysis› outcome and agree on the hedge execution plan.
- Given the complexity of the debt profile, we conducted a market study and implemented several qualitative and statistical techniques, including Monte Carlo Simulation, for risk quantification, which was provided to the client for consideration. The study assisted the sponsors in understanding the benefits and trade-offs between different hedge strategies.
- Considering the project company's interest rate sensitive financial model and short-term liquidity constraints, we simulated various hedging strategies and identified an optimal strategy that achieved the intended risk protection and liquidity objectives.

OUTCOME

- Ehata demonstrated the risk profile of the recommended approaches. The company's management benefited from the clear visibility around the optimal approach. We also addressed the future hedging needs and pre-hedging considerations for the client.
- We assisted the project company with compliance with a fair and transparent hedge execution protocol via organizing formal dry-runs and numerous offline benchmark calls with the bank.
- Ehata facilitated sourcing a third-party non-lending hedging bank to participate in the bidding process to ensure fair and transparent hedge execution.

We have proudly Served

TESTIMONIALS

We can honestly say that we benefitted hugely from having a thoroughly dedicated and independent hedge advisor with local expertise to assist us in formulating an optimal solution to achieve our objectives. Our team has truly learnt valuable lessons from our partnership with Ehata

Ehata has fulfilled a significant engagement with us in setting up the right hedging governance framework to manage the future risk management decision-making process

Ehata acted as a trusted business advisor for us during our interest rate risk management process while providing enriching insights on detailed interest rate market risk study. This helped us in having a better understanding of our interest rate market risk exposure, ultimately leading us to make an informed decision and select appropriate derivative instrument accordingly

CLOSING REMARKS

FAISAL **ALJASIR**
Partner

As one chapter ends, a new one starts. Last year was a year marked with constant change. Even with the headwinds created by the Delta COVID-19 variant, economies globally are on their own pathway of recovering. Locally, there have been plenty of developments in 2021 that could change the economic narrative of the pandemic era.

We have seen a cautious shift in sentiment in global and local interest rates outlook. Rising inflation and the need for monetary policy normalization have been a dominant topic across the previous year. We have observed an increasing number of our clients positioning their borrowing portfolios last year to these changing dynamics, and we expect this to continue in 2022.

Foreign exchange volatilities and the increasing prices of commodities were critical factors in business performance and profitability. We expect more corporates to incorporate risk management trends into existing procedures for identifying and responding to market-driven procurement opportunities. The adoption of IFRS 9 hedge accounting has remained, as more and more of our clients are electing to apply the accounting treatment by better aligning hedge accounting with their risk management strategy.

As we embark on a new year, there are numerous global risk trends that we expect corporates to face one way or the other, given how risks are interconnected. For one, the implications of LIBOR cessation have been one topic that some of our clients have started to consider seriously, and since then we have been closely working with them towards achieving smooth and successful transition.

Locally, we noticed how corporates continue to pursue digitization and adoption of technologies that enable them to reshape their business models and cost base. We have also witnessed the significant acceleration of Fintech that we expect to inevitably lead to new risks, whether market, credit, or operational. In the local stock market, post the successful launch of the MT30 index future in 2020, we expect to see the further introduction of exchanged derivatives that will enhance market participants' options in managing their financial risks.

As we look ahead, Ehata Financial continues to strive towards fostering and grooming local talents. Our training and internship programs have been in full throttle during the last two years. We believe that the need for qualified financial risk managers is essential and will only increase in demand as we navigate these ever-changing markets. We believe our commitment towards our clients in the previous year had significantly strengthened. As an independent firm, we don't just engage our clients; we partner with them and face the unique challenges presented by their operating model together. Our clients' trust is what keeps us going. We look forward with optimism for a new year where we continue to play our part and have a positive impact on our community.

We Are Here to Help

King Fahad Road,
Avenue Building,
5th Floor

+966 11 2255543

Info@Ehata.com.sa

Ehata Financial

@EhataFinancial

www.Ehata.com.sa

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