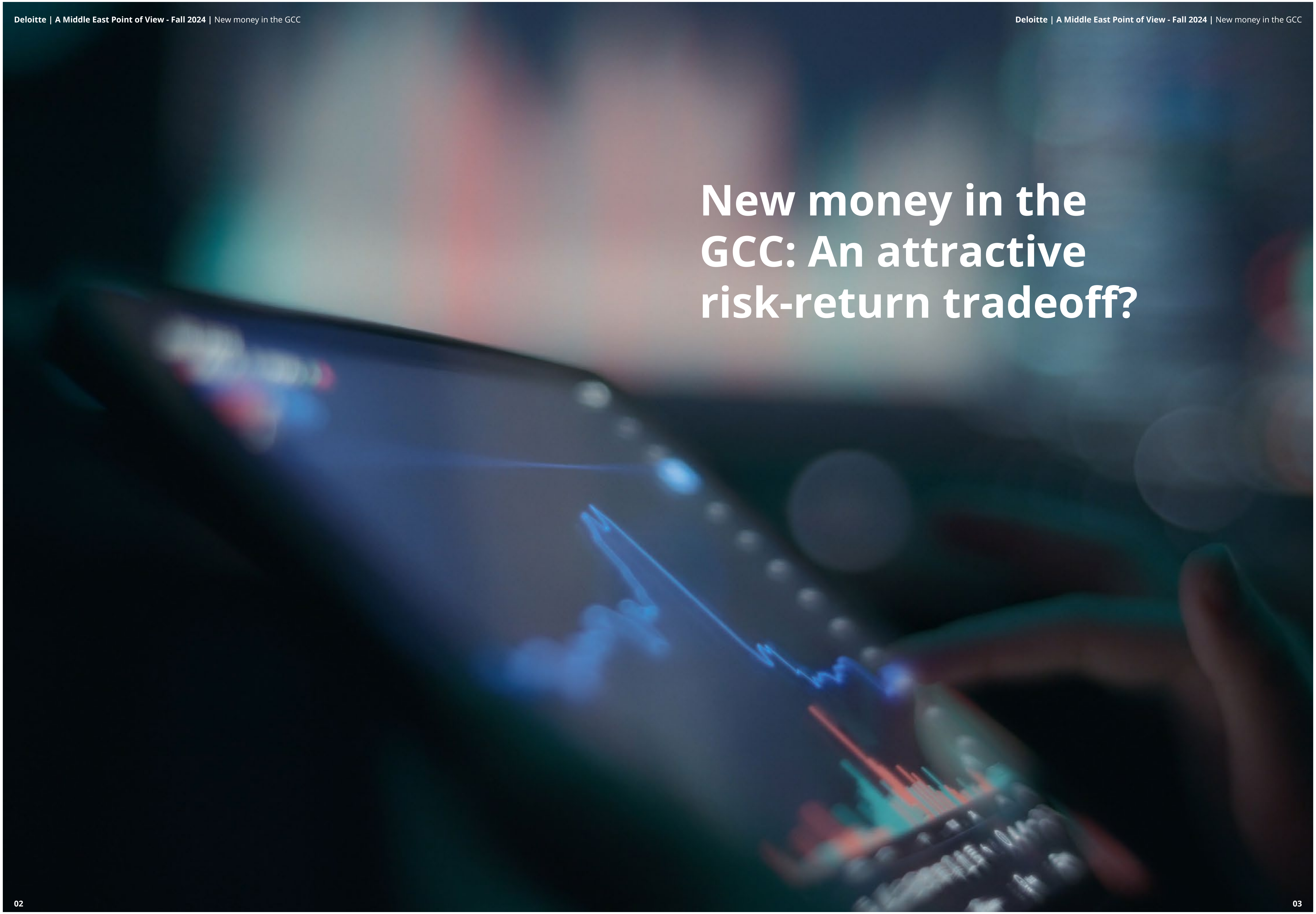
Deloitte | A Middle East Point of View - Fall 2024 | New money in the GCC



New money in the GCC: An attractive risk-return tradeoff?

After more than a decade of a loose monetary environment, policymakers began restricting access to capital in 2022, resulting in a more constrained financial backdrop. The effects of higher interest rates became evident across the globe, including the Middle East, with certain sectors and regions more negatively impacted than others. Cash regained its central importance as businesses scrambled to secure liquidity, either by optimizing internal cash generation or seeking external sources. Company boards faced continuous challenges, as they operated around the precarious zone of insolvency, where, according to available data from the UK[1], recoveries can be impaired for all stakeholders.

The central question then becomes: what are some potential avenues to inject liquidity and improve overall outcomes?

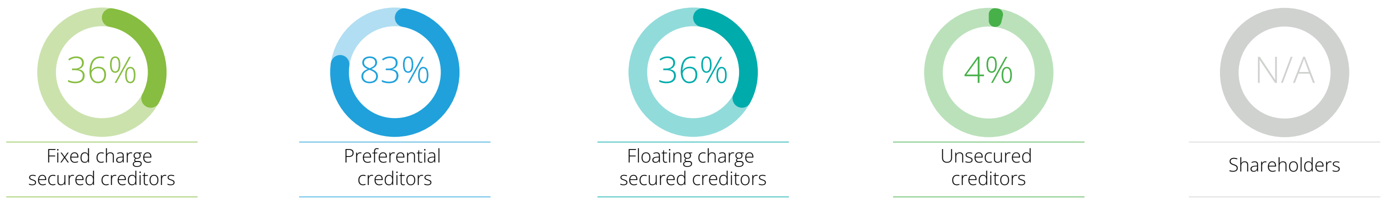


Figure 1: Average debt recovered (% of outstanding claim)

Source: HM Treasury, Budget 2018, 'Protecting your taxes in insolvency,' (2018)

The central question then becomes: what are some potential avenues to inject liquidity and improve overall outcomes? Bankruptcy law reforms in the UAE (2016 Federal Bankruptcy Law, revised in 2023) and KSA (2018 Bankruptcy Law) create opportunities for debtor-in-possession (DIP) financing which may offer new money providers an attractive risk-return tradeoff.

New money

Caught between a lack of cash and the threat of insolvency, directors of the borrower must pivot quickly. At a minimum, the chief financial officer (CFO) must ensure that employee salaries are paid and supplier balances are settled. The challenge is that, during such crises, cash becomes particularly scarce as existing lenders have become exhausted. Introducing new funding could offer relief, effectively buying time for a turnaround. Based on the structural characteristics of the company's balance sheet and the availability of unencumbered assets, directors could seek additional liquidity through a consensual process, potentially involving existing creditors, or by initiating a time-out using applicable statutory tools in the relevant jurisdiction.

Out-of-court

Directors may consider exploring out-of-court options to retain autonomy in managing the company. Creditors may also favor out-of-court solutions to avoid the potential compromise of their claims. However, some degree of compromise among different parties, including shareholders, is often necessary to reallocate value, particularly to attract "new money" providers to support the company's recovery. Therefore, the following are expected to be key ingredients for a successful consensual injection of new money:

1. Unencumbered assets: If assets are available to serve as collateral for the new funding provider, this will encourage a quicker capital injection. The absence of unencumbered assets will necessitate careful negotiations among creditors to release or share security.
2. Intercreditor agreements: Careful management of intercreditor positions is essential to either respect or subordinate the rights of other stakeholders.
3. Equity upside: The equity value of a financially distressed business is often low and, in certain circumstances, could be negligible. Additional liquidity could help revitalize the business, and therefore, may be necessary for shareholders to offer a portion of equity in return.

As initial participants in the situation, existing lenders likely possess an informational advantage and may be best positioned to provide additional credit to the debtor under preferential terms. In the US Chapter 11 framework, historical data[2] suggests that 83% of DIP loans are provided by existing creditors and shareholders.

"Time-out" with court protection

When there are no unencumbered assets, creditors are unwilling to share security, and shareholders cannot relinquish their equity claims, company directors may need to seek court protection in order to reorganize the capital structure under the auspices of a moratorium on creditor claims. Recent amendments to bankruptcy laws in the United Arab Emirates and Saudi Arabia aim to encourage rehabilitation, including accessing new funding through DIP financing (as seen on some of the larger restructurings to date). Considering the emerging legal framework for new funding in the region, it is useful to examine the appeal of DIP financing based on empirical evidence from the United States[2,3] and the Chapter 11 process, specifically:

1. DIP financing as a governance tool for lenders: During periods of loose monetary policy, when covenant-light agreements are common, DIP financing is structured with tailored terms to enhance lenders' oversight of the debtor.
2. Roll-up: Existing lenders providing additional funding to the debtor may enhance their overall recoveries by incorporating some of their existing exposure into the new financing package. There is also the opportunity to provide exit financing once the debtor emerges from the Chapter 11 process with a restructured balance sheet.
3. Low repayment risk: Depending on the period considered, DIP financing in the United States has typically had a repayment risk of 0.08%, accounting for both principal and interest. However, lenders may need to be comfortable equitizing some of their existing exposure.
4. Attractive pricing: DIP financing features higher average spreads, along with various additional fees such as monitoring, commitment, and exit fees.
5. Shorter maturity: A key condition for DIP financing is for the debtor to exit the Chapter 11 process within a short timeframe. As a result, new funding typically has a maturity of 9 to 12 months, which, when combined with the roll-up option, can expedite the repayment of a lender's existing exposure.

Recent regulatory reforms in the GCC and the growth of local credit markets have made DIP financing a compelling solution for companies aiming to recapitalize in distressed situations, as well as for lenders seeking an attractive risk-return profile. However, not all financially strained borrowers will have the appropriate capital structure or business profile for new capital injections. In such cases, restructuring under local insolvency laws may be necessary to optimize the balance sheet before pursuing exit financing to support business recovery.

By **Thomas Bullock**, Partner and **Vuk Prelevic**, Director, Strategy & Transactions, Deloitte Middle East

Endnotes

1. M Treasury, Budget 2018, 'Protecting your taxes in insolvency', (2018).
2. Eckbo, B. Espen and Li, Kai and Wang, Wei, 'Loans to Chapter 11 Firms: Contract Design, Repayment Risk, and Pricing', Journal of Law and Economics, vol. 66 (August 2023)
3. Skeel, David A. Jr., 'The Past, Present and Future of Debtor-in-Possession Financing', Cardozo Law Review (2004).

Deloitte | A Middle East Point of View - Fall 2024 | New money in the GCC