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The Financial Restructuring landscape in KSA

The key drivers that have shaped stakeholder dynamics within the Kingdom's restructuring market

The financial restructuring landscape in the GCC and Saudi Arabia in particular has been molded by a myriad of factors from fluctuations in oil prices and COVID-19, to shifting macro-economic conditions and the challenges they entailed.

Government responses to these challenges include fiscal and monetary policies, economic stimuli, relief measures, as well as regulatory frameworks to mitigate and govern business activities and corporate underperformance. These are some of the key drivers of the evolution that the restructuring market in the Kingdom has witnessed.

Corporates and lenders alike have changed their perspective in terms of how underperformance and liquidity issues can and should be dealt with. A more collaborative approach amongst stakeholders involving financial, legal and trustee advisors has proven successful.

This article outlines key market dynamics between governments, corporates and financial institutions and how these dynamics shaped recent activities in the restructuring market in light of the prevailing changes within the macro-economic environment.

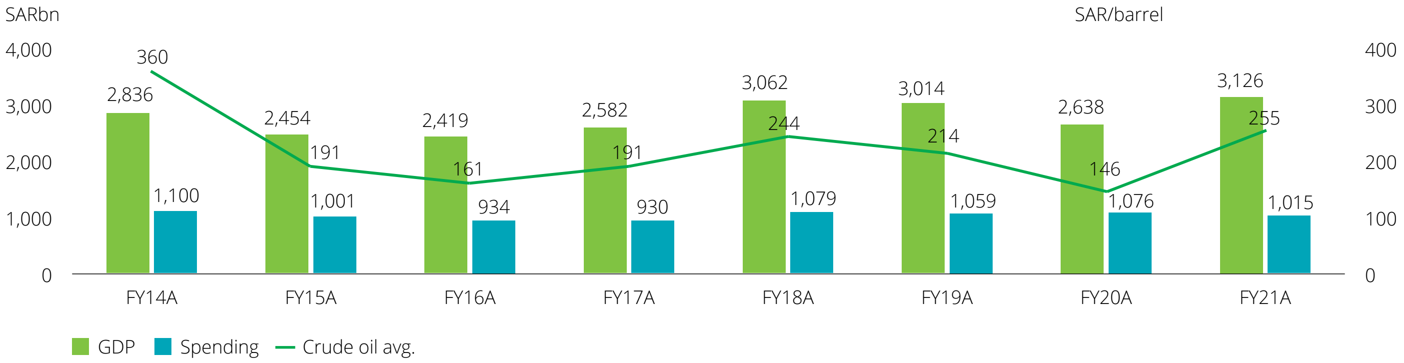
Macro-economic drivers

In the wake of the 2008 financial crisis, GCC countries exhibited signs of economic growth spurred by an increase in oil prices that hovered around USD 100 (SAR 375) per barrel between 2011 and mid-2014 as per the World Bank Commodity Price data.[1] However, these economies were subsequently affected by the supply-driven oil price dip that started in the third quarter of 2014 and lasted until late 2021, consequently impacting budgets and economies of oil producing governments.

Between 2014 and 2017 in Saudi Arabia, annual government expenditures were reduced from SAR 1,100 billion to SAR 930 billion as per the Ministry of Finance budget statements. In addition, a number of fiscal policies were announced in an attempt to balance government budgets by compensating for the deficit between break-even levels of more than USD 82 (SAR 308) per barrel (based on average breakeven fiscal oil prices for Saudi Arabia as per the International Monetary Fund (IMF)) and the prevailing oil prices that ranged between USD 35 (SAR 131) and USD 75 (SAR 281) per barrel as per the World Bank Commodity Price data.

This situation was exacerbated by the advent of COVID-19 that struck in the fourth quarter of 2019. Oil prices reached the lowest level in 20 years, USD20 (SAR 75) per barrel in April 2020, seemingly directly impacting Gross Domestic Profit (GDP).

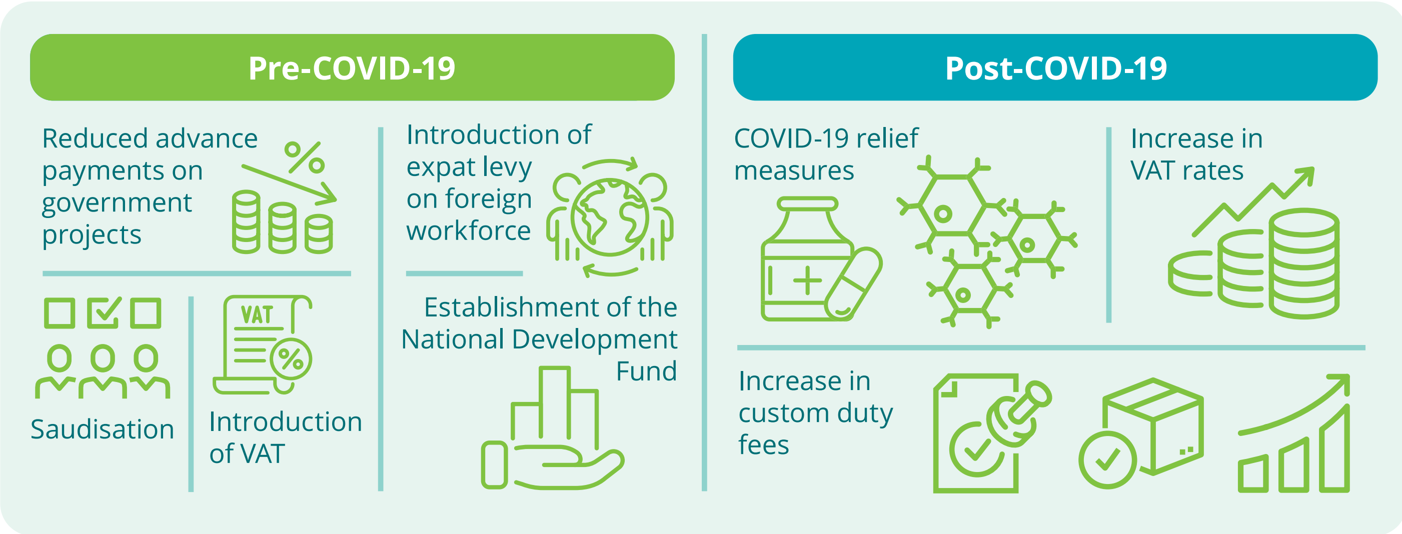
Oil prices, Saudi Arabia GDP and government spending



Source: IMF and KSA Ministry of Finance

1. https://www.worldbank.org/en/research/commodity-markets

Government response measures



Pre-COVID-19

Response policies in the form of new regulations were enacted in an effort to mitigate the impact of the aforementioned macro-economic challenges, diversify the government's sources of revenue and improve fiscal position.

In April 2016, Vision2030 was launched, a strategic plan to transform the nation's economy, reduce its dependence on oil and increase the contribution of the private sector. This is being done through launching mega-projects with a total project value of more than USD 1,000 billion (SAR 3,750 billion), as per MEED projects. The aim is to support small and medium enterprises through promoting local content and national industries while developing promising economic sectors such as the renewable energy sector and the tourism and entertainment sector.

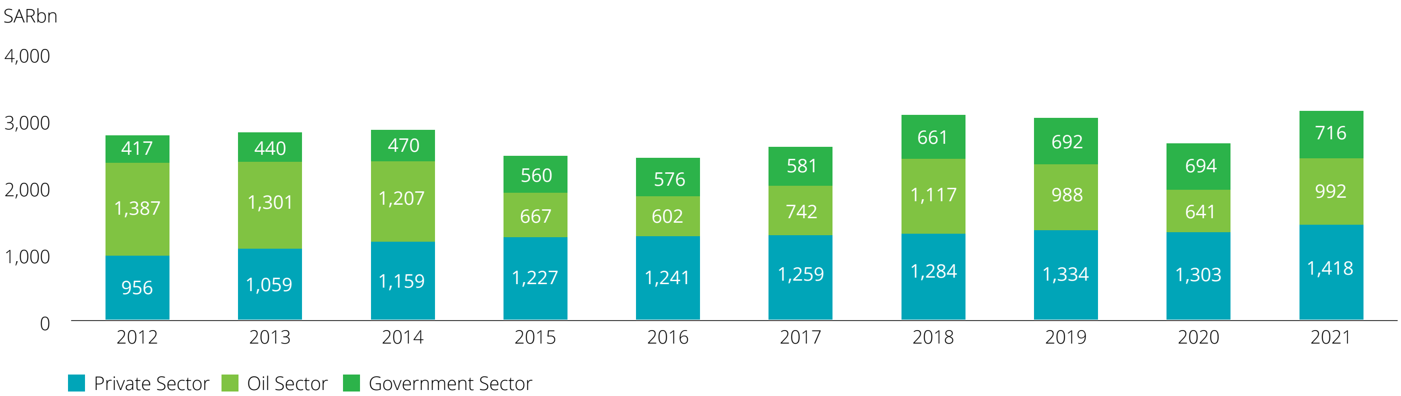
In 2021, private sector contribution reached 45.4% of GDP compared to 34.6% in 2012 and is expected to reach 65% in later years as per the Vision2030.[2]

In 2018, the KSA government introduced the expatriate levy on foreign workforce – a staggered increase in fees reaching SAR 700-800 per month per employee for a work permit renewal, compared to SAR 333 per month in 2017, depending on Saudisation levels.

In addition, a 5% VAT was put into effect during the same year which was applied on imports and provision of goods and services, with a few exceptions such as the lease of residential properties.

Several sectors namely oil and gas, construction and real estate which are heavily reliant on government spending were thus adversely impacted primarily due to a reduction in project awards.

Gross Domestic Product by sector



Source: General Authority for Statistics

2. https://www.vision2030.gov.sa/

Post-COVID-19

COVID-19 had a severe impact on the global and regional economies; GCC governments simultaneously announced and implemented several relief measures in the form of tax exemptions, government fees refunds, loan settlement deferrals and fee waivers amongst others to alleviate the detrimental impact of COVID-19.

Despite these measures, fiscal policies were tightened during the pandemic as oil prices hit a record low of USD 20 (SAR 75) per barrel in April 2020 due to an oversupply in the market, resulting from the lockdown and tight measures taken by governments to fight the pandemic.

In addition, the Saudi Arabian government increased VAT rates from 5% to 15% as of July 2020 to absorb some of the impact of oil price declines. Similarly, custom duty fees were increased and ranged between 5.5% to 20% for several product categories leading to corporates seeking to alter their supply chain channels.

Since then, oil prices have gradually increased, averaging around USD 102 (SAR 383) per barrel in August 2022, due to the recovery in demand with COVID-19 restrictions lifted in most countries, and fears over shortages of supplies due to the Ukraine war. While oil prices remain unstable with a lack of certainty over future prices, the recent increase has had a positive income on the KSA government income and wider economy. With government-sponsored project awards/values increasing, distressed companies can be better positioned to turnaround their businesses and have better grounds to implement restructuring plans – operationally and financially.

Impact on corporates and lenders

The knock-on effect from the macro-economic factors on government budgets and the resultant compensatory measures had a compounded adverse effect on corporates profitability, as both top-line and profit margins have been affected.

Downscaled government budgets impacted project awards and revenues of corporates across a multitude of sectors, primarily construction. For instance, USD 180 billion (SAR 675 billion) worth of construction projects were put on hold or cancelled between 2014 and 2018 of which USD 27 billion (SAR 101 billion) were governmental projects (source: MEED projects).

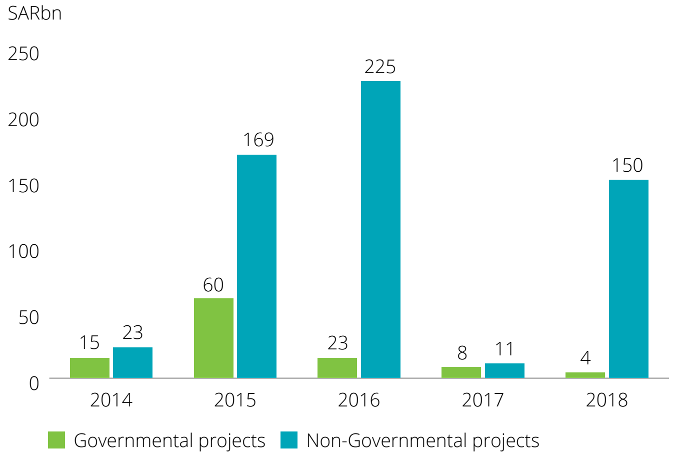
This was coupled with an increase in the base cost as a result of tightened fiscal measures i.e. higher input cost as a result of higher VAT and custom duties and higher staff costs given expat levies and Saudisation requirements.

Simultaneously, liquidity challenges were accentuated, especially in the case of corporates working directly with governmental entities, given excessively longer receivable cycles and payment delays.

Many corporates attempted but failed to secure new funding to circumvent liquidity challenges and as a result engaged in prolonged restructuring discussions with financiers and creditors. In some instances, corporates faced the risk of a potential business closure and hence drastic restructuring procedures were required to save these businesses, including utilising the KSA bankruptcy law.

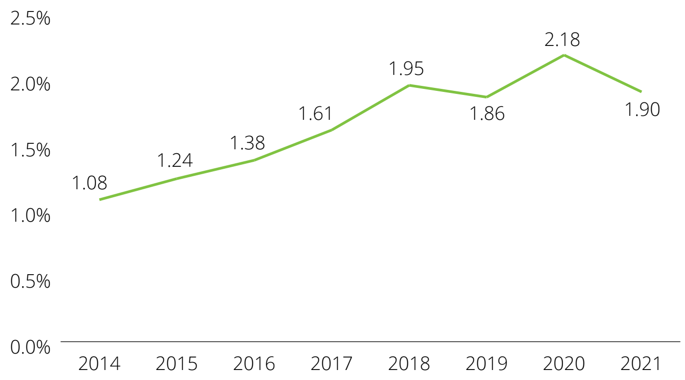
As a result, corporate defaults on debt obligations soared, thereby increasing non-performing loan (NPL) exposures for KSA financiers to reach SAR 32.9 billion by the end of the second quarter of 2021 as per the Saudi Gazette article "Non-performing bank loans in Saudi Arabia reach SAR33 billion" published on the 21 August 2021..

Project holds/cancellations in Saudi Arabia



Source: MEED projects

Bank nonperforming loans ratio



Source: Worldbank

Banks response

Banks started exploring various recovery options to proactively manage NPL exposures.

1. Debt referrals or write offs, in the event where financial and/or operational turnarounds can still be implemented.

Deferring or writing off debt, was sought in order to support businesses in aligning their forecast cash generative ability with debt service capacity. However, banks and corporates alike needed to have comfort that financial forecasts and resultant restructuring solutions are sustainable a nd are based on reliable business plans that are driven by elements of turnaround.

2. Legal recovery

In cases where businesses no longer had commercially viable value propositions, some banks sought legal routes and established debt recovery units within their special asset management functions.

3. Distressed loan sales are some of the options available for lenders who no longer believe in the value propositions of the businesses.

In other instances, banks may decide to clean their balance sheets from NPLs through the sale of distressed loans, however, this continues to present a set of commercial, practical and legal challenges that need to be addressed. The market for sale of distressed loans remain very limited in the GCC, as Central Banks and other bodies ensure that regulatory measures surrounding such transactions are adequately in place.

Regulatory frameworks to govern the implication of corporate underperformance

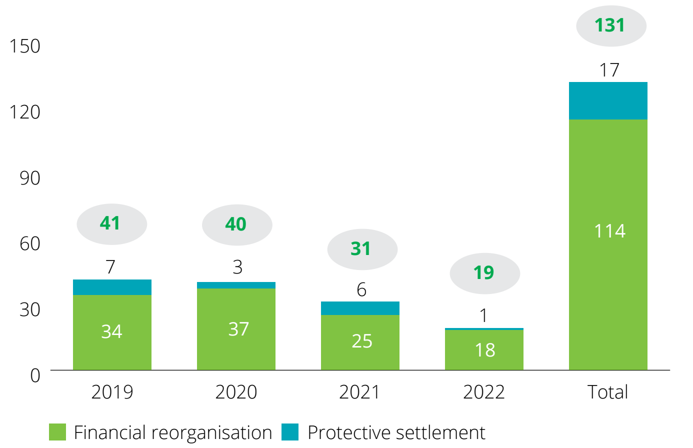
The KSA government has taken the initiative to establish framework and guidance to address underperformance and insolvencies from corporate and lenders standpoints.

KSA bankruptcy law

The KSA bankruptcy law was introduced in 2018 with a primary aim to provide financially stressed businesses with a platform that facilitates the implementation of restructuring plans. In light of the macro-economic fluctuations outlined earlier in this article, this law is expected to continue playing a critical role in facilitating the turnaround of Saudi corporates.

As per the Bankruptcy Commission, 131 cases of Financial Reorganisation and Protective Settlement Procedures were registered under the law since it was introduced and up until 31 July 2022 comprising corporates of various sizes. Since then, Deloitte has been at the forefront in terms of acting both as restructuring and trustee advisors on some of the largest financial restructuring cases under this Law – with more than USD 12 billion (SAR 45 billion) in liabilities successfully restructured.

Number of bankruptcy cases by procedure (as of 31 July 2022)



Source: KSA Bankruptcy commission

SAMA guidance to banks on management of problem loans

The Saudi Central Bank (SAMA) issued rules effective 1 July 2020 outlining the key procedures to be implemented by commercial banks in KSA with respect to the management of NPLs. The primary aim of these rules is to help develop the existing financial restructuring practices adopted by lenders while dealing with distressed debtors.

The enacted guidance primarily covers prevention and identification of NPLs including the development of a NPL strategy. It also established restructuring units to operate independently from loan originating units with well-defined restructuring policies, with an aim to develop sustainable restructuring plans with borrowers.

The need for restructuring specialists

The aforementioned drivers and dynamics created an opportunity that highlighted a strategic need for restructuring professionals in the Kingdom.

Special asset divisions established themselves within Saudi banks – debt restructuring (including remedial and debt recovery/litigation) professionals became in high demand and started leading work-out units and implementing the SAMA guidelines. Tasked to work alongside the debtors to develop work-out plans with underlying sustainable restructuring solutions, they required restructuring counterparts from the corporates' side to articulate such solutions based on robust and bankable business plans.

As corporates resorted to downsizing their workforce in an attempt to align cost structures with lower trading levels, key management personnel dedicated time and effort to run day to day operations of what had become distressed businesses and therefore lacked the bandwidth to develop strategic business plans and longer-term solutions. In addition, the latter tasks required certain levels of expertise that businesses normally do not possess, creating an opportunity for independent financial advisors to bridge this gap.

The role of financial restructuring advisors

Financial advisors have taken on company-side and bank-side mandates depending on the situation and the readiness of target businesses to drive a restructuring process. More mature businesses with an established management team that had developed a business plan tend to engage with independent financial advisors to undertake an independent business review, typically with duty of care to the lenders.

In other instances, financial advisors would take a more active role in supporting the management teams in developing business plans and restructuring options.

In both cases, the role of financial restructuring advisors is seen as critical to the success of the transaction as it offers an independent and trusted 'broker' to facilitate a complex negotiation between the corporates and their creditors.

The market has also witnessed restructuring professionals embedded within the management teams of corporates and acting as Chief Restructuring Officers (CROs) in order to develop the restructuring plan from both financial and operational perspectives, and at a later stage implement the turnaround roadmap and underlying initiatives once the plan is agreed.

Depending on the complexity of the restructuring solutions being proposed, especially with in-court restructurings under the KSA bankruptcy law, corporates also require legal advisors with restructuring backgrounds to work alongside their in-house legal counsels and management teams.

In conclusion

Prevailing macro-economic conditions, liquidity challenges impacting corporates and lenders alike, and regulatory responses including SAMA led initiatives and the launch of the KSA bankruptcy law were all key catalysts to the evolution and the growth of the restructuring market in Saudi Arabia.

As the tide starts turning and economic recovery unfolds, having these platforms and frameworks established, coupled with support from lenders and specialised advisors, the collaboration should position corporates well to turnaround their business to ride the wave of economic growth.

It is important for corporates, shareholders and creditors to appreciate that a successful financial restructuring is not the objective in itself but rather the first step in the path to a successful turnaround. Once a financial restructuring is complete, corporates can focus on developing and implementing a robust operational turnaround plan, underpinned by appropriate corporate governance structures.

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