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MENA INTELLIGENCE

A MARKAZ Subsidiary

July 2020

GCC Risk Premium – H1 2020

A Toolkit for Corporate Financiers



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Table of Contents

CHAPTER 1

Executive Summary

CHAPTER 2

Why worry about WACC (Weighted Average Cost of Capital)?

CHAPTER 3

Country wise Commentary

CHAPTER 4

Appendix



Chapter 1

Executive Summary

The outbreak of the COVID-19 pandemic in early 2020 in China and its worldwide spread has had a mixed impact on the cost of capital of GCC countries. GCC countries with investment grade ratings have seen a fall in their cost of capital while Bahrain and Oman, the two GCC members with sub-investment grade rating have seen their cost of capital increase in H1 2020 compared to H1 2019. An important factor has been the flight to safety by investors, which has resulted in a fall in 10-year U.S treasury yields as well as that of GCC countries' sovereign yields except Bahrain and Oman. The successive rate cuts by the U.S. Fed in March 2020 have also helped in significant decrease in the sovereign yields for Saudi Arabia, Kuwait, Qatar and UAE. This has resulted in overall reduction in cost of capital for these countries.

In June 2020, Moody's Investors Service downgraded the long-term issuer ratings of Oman to 'Ba3' with negative outlook from 'Ba2' negative outlook. The ratings agency had earlier downgraded Oman from 'Ba1' to 'Ba2'. It cited the low oil-price environment, which is likely to persist in the medium term and erosion in the foreign currency sovereign reserves as reasons for the downgrade. As a result, Equity Risk Premium for Oman increased.

While Bahrain did not see a downgrade from Moody's in 2020, S&P Global ratings downgraded Bahrain from BB to BB- in March 2020. In May 2020, Bahrain received USD 4.57billion in financial aid from Saudi Arabia, Kuwait and UAE as a part of the rescue package agreed in 2018. However, S&P believes Bahrain would need additional support

Cost of capital under the CDS method has decreased for all GCC countries except Oman, Dubai and Bahrain primarily due to the fall in risk-free rates and due to the lower CDS spreads for the respective countries.

For GCC countries other than Bahrain and Oman, the cost of capital decreased due to fall in risk free rates as their credit ratings remained unchanged. The 10-year U.S. treasury yield has fell from 2.00% in Jun-2019 to 0.70% in Jun 2020 on the back of unprecedented support extended by U.S. Fed amid COVID-19 pandemic. The decrease in Cost of Capital remains capped due to lowered growth expectations for 2020 and beyond. According to IMF, the GCC economy as a whole is expected to contract by 7.6% (Real GDP) in 2020.

Cost of capital (under the implied Equity Risk Premium method) decreased for most GCC countries when compared to H1 2019 values, except for Dubai, Oman and Qatar. Cost of Capital, under the implied ERP method could not be computed for Bahrain, as the yield of the sovereign issue is lower than the default spread based on credit rating. This is because of the difference in the perception of the Bahrain's fiscal situation between the market and rating agencies.

GCC Cost of Capital, H1 2020

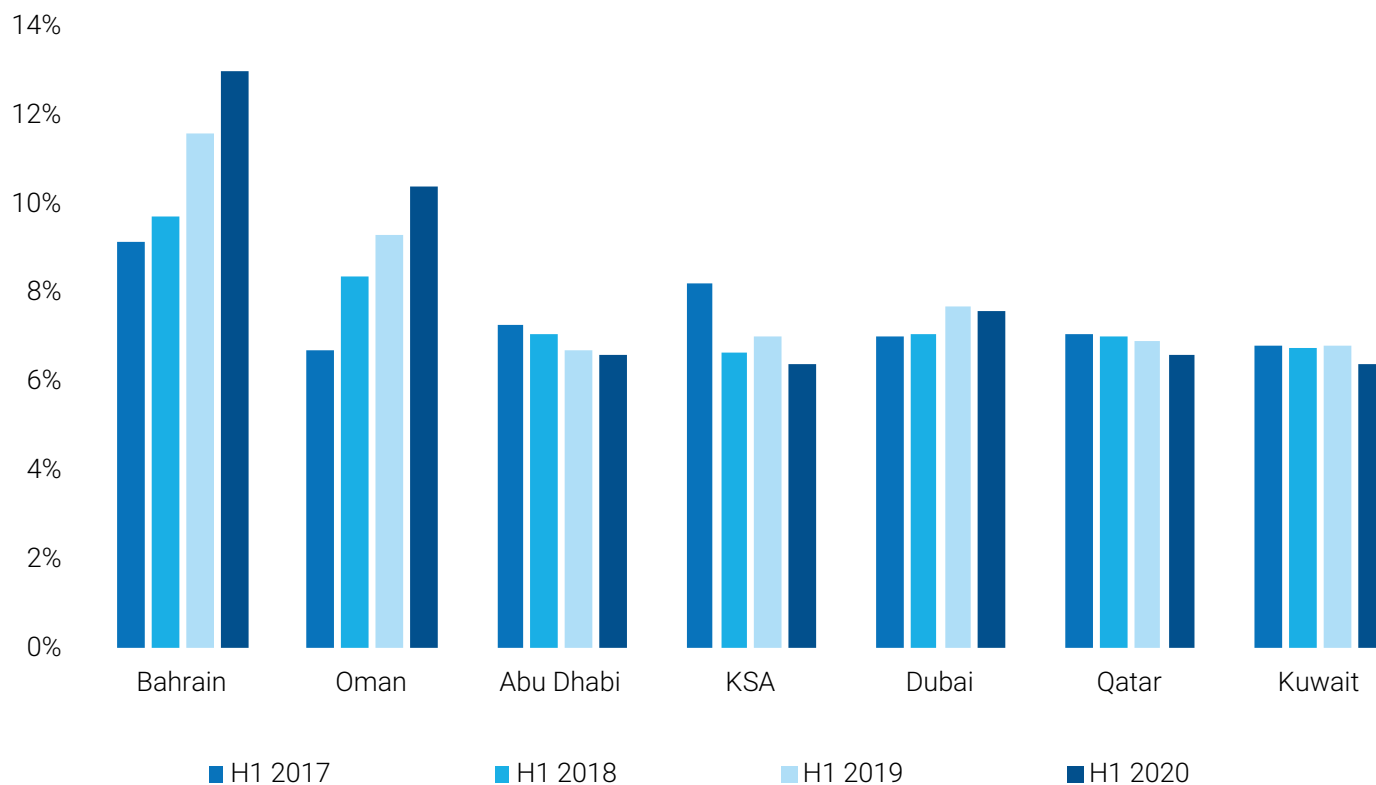
	Cost of Capital, WACC							
	Implied ERP Method		CDS Spreads Method		Ratings Method		Average	
	H1 2020	H1 2019	H1 2020	H1 2019	H1 2020	H1 2019	H1 2020	H1 2019
Bahrain	N.A	N.A	11.9%	10.7%	14.0%	12.4%	13.0%	11.6%
Oman	8.7%	6.7%	10.3%	9.6%	11.2%	9.0%	10.4%	9.3%
Abu Dhabi	6.7%	6.9%	6.6%	6.8%	6.6%	6.7%	6.6%	6.7%
KSA	5.5%	5.5%	6.9%	7.1%	6.9%	6.9%	6.4%	7.0%
Dubai	7.0%	6.9%	8.3%	8.0%	7.6%	7.5%	7.6%	7.7%
Qatar	6.3%	6.1%	6.7%	6.9%	6.7%	6.8%	6.6%	6.9%
Kuwait	5.8%	6.5%	6.7%	6.9%	6.6%	6.7%	6.4%	6.8%

Source: Marmore Research;

Other Assumptions: D/E ratio of 0.5, Beta of 1.0, Cost of Debt: 5%

Since H1 2017, the average WACC from the three methods has witnessed a decline for Saudi Arabia, Abu Dhabi, Qatar and Kuwait with the WACC for H1 2020 being the lowest. The opposite trend is observed for Bahrain and Oman with WACC continuously increasing each year. The WACC for Dubai while seeing a mild decline in H1 2020 has been within a tight range for the past four years.

GCC WACC, H1 2017 to H1 2020



Source: Marmore Research; WACC mentioned in the chart is the average of all three methods

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