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GCC WACC H1 2018

A Toolkit for Corporate Financiers

Calculation of equity risk premiums and weighted average cost of capital for GCC countries, using the ratings, credit default spreads and implied ERP methods



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PERIODIC RESEARCH REPORT

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Subsequent to our note published in [February 2018](#), we have updated the values of equity risk premium and cost of capital to reflect the changes in current operating environment. Calculation of risk free rates for GCC countries was previously done by computing the inflation differentials between the country and U.S, and summing it with U.S risk free rate, as most of the GCC countries had not issued sovereign bonds. However, in the recent past all the GCC countries have issued bonds in order to bridge the deficit in their budgets. However, due to the absence of active trading of the locally issued bonds, the yield data obtained from bonds is often stale. Hence, we have used the summation of the 10yr U.S treasury yield and country specific sovereign risk premium to compute the risk free rate.

In March 2018, Moody's Investors Service lowered the long-term issuer and senior unsecured bond ratings of the government of Oman to Baa3 from Baa2. The agency cited that there was an absence of significant measures to narrow the fiscal and

current account deficits, which would further weaken Oman's capacity to absorb potential shocks, as the reason for the downgrade. CDS spreads were significantly higher in H1 2018 for Bahrain and Oman mainly due to the sell-off in emerging market debt. In Bahrain's case, the effect was amplified by the weakness in the government's finances. Bahrain's CDS swaps reached record highs during June 2018, similar to the levels witnessed in Feb 2016, when oil prices were at around USD 30 per barrel.

Cost of capital (under the implied ERP method) increased for most GCC countries when compared to H2 2017 values, with Bahrain being the exception. Cost of capital under the ratings method has increased for all GCC countries compared to H2 2017, as multiple hikes in U.S Fed rates during H1 2018 have led to the rise in risk-free rates. Similarly, cost of capital under the CDS method has also increased for all GCC countries primarily due to the rise in risk-free rates, and in some cases due to the widening of CDS spreads for the respective countries.

GCC WACC, H1 2018

	WACC (Implied ERP)		WACC (CDS Spreads)		WACC (Ratings)	
	H1 2018	H2 2017	H1 2018	H2 2017	H1 2018	H2 2017
Bahrain	7.0%	7.2%	11.0%	10.1%	11.2%	10.9%
Abu Dhabi	6.9%	6.6%	7.2%	6.9%	7.1%	6.7%
Dubai	7.0%	5.6%	8.1%	7.2%	7.7%	6.7%
Qatar	6.4%	6.1%	7.5%	7.1%	7.2%	6.9%
Kuwait	5.9%	5.9%	7.3%	6.9%	7.1%	6.7%
KSA	5.1%	4.8%	7.6%	7.2%	7.3%	7.0%
Oman	6.5%	6.2%	9.7%	8.9%	8.9%	8.2%

Source: Damodaran, Marmore Research;
Other Assumptions: D/E ratio of 0.5, Beta of 1.0, Cost of Debt: 5%

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Why worry about WACC?

Cost of capital represents the opportunity cost of all financial capital, primarily debt and equity, invested in an enterprise. Opportunity cost is what is given up as a consequence of your decision to use a scarce resource, such as financial capital, in a particular way¹. 'Opportunity cost' also referred to as 'hurdle cost' or 'discount rate', is of primary importance in valuation and helps the management in identifying projects, which add value to the enterprise.

Given the importance of this metric in creating value for shareholders, it is essential to understand how it is computed. Though in reality it is surprising to note that not much effort is invested in calculating cost of capital; while a significant amount of time is focused on forecasting uncertain future cash flows. Improper capital cost assumptions could lead to type-I error (accepting projects that do not add shareholder value) or type-II error (rejecting projects that add shareholder value).

In order to compute the cost of capital, we start by finding the cost of each capital component that the firm utilizes. Cost of capital primarily consists of equity and debt costs, weighed according to the proportions of debt and equity capital in the capital structure. The cost of debt can be inferred easily as it entails specific cost in the form of interest payments made in cash. The entire debt mix including money market debt in the form of commercial papers/notes, bank debt in the form of loans/overdraft, financial leases and bonds raised is aggregated. The interest payments made as a proportion of interest bearing debt instruments provides us with the debt cost.

Unlike debt holders, equity holders do not demand an explicit return on their capital. However, equity holders incur an implicit opportunity cost for investing in a specific company, because they could invest in an alternative company with similar risk profile². Equity cost involves various factors such as risk free asset, beta, market risk premium, country risk premium among others. Beta – a measure of priced risk, is arrived by regressing the past price returns on an index. As private firms do not trade, estimation of beta becomes a complex process for private firms.

In order to estimate the value of beta for a private firm, we create a list of comparable public firms operating in the same industry. Firms with similar line of business and asset size would typically be considered as a good comparison. To ensure we have zeroed down on appropriate comparable enterprise(s), a simple regression test between the revenues could be done. Firms, which are affected by similar economic and industry factors, in general, would exhibit higher correlation.

Once the publicly listed comparable list is drawn, we may average their beta values and leverage ratios to arrive at levered beta for the particular sector or industry. This levered beta is then unlevered to arrive at the beta for the industry/sector. The unlevered beta could then be levered based on the debt to equity (D/E) ratio for the private firm. One may either use the management target set for debt to equity ratio or the industry average to re-lever the unlevered beta. Considering this as beta for the private firm, we

proceed with the calculation of cost of equity using the Capital Asset Pricing Model (CAPM)³.

Part I. Cost of Equity

Capital Asset Pricing Model (CAPM) states that the equity investors in addition to risk free rate demand a premium for bearing the extra risk of enterprise operations. The additional risk is referred to as Equity risk Premium (ERP). ERP for a company is dependent on the "beta" which measures the relative risk of the company with respect to the entire market.

CAPM can be expressed mathematically as,

$$\text{Cost of Equity, } K_e = \text{Risk free-rate, } R_f + \text{Beta} * (\text{ERP})$$

The easy way out to calculate ERP is to find the difference between historic long-term return of equity index and the risk-free investment, such as government bonds. Though it appears simple, the methodology has its drawbacks especially for emerging and frontier countries like the GCC region

Current Yields of 10-Yr International Sovereign Issues

Country	Yield
Kuwait	3.88%
Dubai	3.99%
Abu Dhabi	4.04%
KSA	4.27%
Qatar	4.39%
Oman	6.48%
Bahrain	8.17%

Source: Reuters; Note: Yields of latest 10-yr international sovereign bonds, as of June 30, 2018

3. Almost all GCC exchanges are still undergoing a lot of transformation in terms of regulations, trading platforms, instrument availability, and corporate disclosures. This coupled with nascent secondary market for bonds will make the risk premiums calculated with historical numbers inaccurate.

While the traditional way of calculating ERP has many obstacles due to lack of data and volatile

1. Until recently, not all GCC Countries had instruments that could be considered risk free. This was either because sovereign bonds were not issued (Ex. Kuwait) or because governments may have default risk (Ex. Dubai). In such cases, we found the nominal yield of 10-yr US treasury and add inflation differential for the country compared to U.S in order to arrive at the risk free rate. In the recent past, all the GCC countries have issued bonds in order to bridge the deficit in their budgets. However, due to the absence of active trading of the locally issued bonds, the yield data obtained is often stale. Hence, we have used the summation of the 10yr US treasury yield and country specific sovereign risk premium to compute the risk free rate.
2. Equity markets are volatile and risk premiums calculated with short historical data experience significant estimation errors.

nature of equity markets in the region, we compute Equity Risk Premium data using alternate methods such as:

a. Sovereign Rating

Taking the U.S market's equity risk premium (ERP) of 5.4%⁴, the ERP of GCC countries are arrived at by adding the default spread based on their credit rating:

¹ Prof. Aswath Damodaran

² Ibid

³ We have illustrated the cost of equity calculation using CAPM methodology, as it is popular and widely used. Other available methods include Arbitrage Pricing Theory and Fama French three factor model

⁴ Aswath Damodaran- 1st January 2018

ERP for GCC Countries based on Credit Rating

Country	US Eq. Risk Premium	Rating	Default Spread	Total Equity Risk Premium
Bahrain	5.4%	B1	4.62%	10.0%
Kuwait	5.4%	Aa2	0.51%	5.9%
Oman	5.4%	Baa3	2.26%	7.6%
Qatar	5.4%	Aa3	0.62%	6.0%
Saudi Arabia	5.4%	A1	0.72%	6.1%
Abu Dhabi	5.4%	Aa2	0.51%	5.9%

Source: Moody's, Aswath Damodaran, Marmore Research

b. CDS Spreads

Rating agencies are generally considered to be slow in updating their ratings. Therefore, instead of arriving at default spread based on rating, we have used CDS spreads as a proxy. In this method, the CDS spread of a country's bond (adjusted for spread of risk free country) is considered as default spread instead of looking at the yield differentials of similarly rated bonds.

The adjusted CDS for Bahrain (4.1%) is the difference between the 10Yr CDS for Bahrain (4.4%) and U.S (0.3%).

ERP for GCC Countries on CDS Spread

Country	US Eq. Risk Premium	10Yr CDS	Adjusted CDS	Total Equity Risk Premium
Bahrain	5.4%	4.4%	4.1%	9.5%
Kuwait	5.4%	1.2%	0.9%	6.3%
Oman	5.4%	4.2%	3.9%	9.3%
Qatar	5.4%	1.5%	1.2%	6.6%
KSA	5.4%	1.5%	1.2%	6.6%
Abu Dhabi	5.4%	1.0%	0.8%	6.1%
Dubai	5.4%	1.7%	1.4%	6.8%

Source: Aswath Damodaran, Thomson Reuters Eikon, Marmore Research

c. Implied ERP

Implied equity risk premium is an alternative approach to estimate risk premiums. Assuming that stocks are correctly priced, if we can estimate the expected cash flows from buying stocks, then we can estimate the expected rate of return on stocks by computing an internal rate of return (IRR). Subtracting out the risk free rate from IRR should yield an implied equity risk premium.

The inputs such as risk free rate and perpetual growth rate, required for calculation of Implied ERP were not readily available for GCC countries. In addition, the lack of consensus earnings growth estimate makes it hard to determine the market's view on growth for the next 5 years.

Implied Risk Premium for GCC Countries

Country	Index Level*	Implied Equity Risk Premium
KSA	8,314	1.7%
Kuwait**	5,439	3.5%
Qatar	9,024	4.3%
Abu Dhabi	4,560	5.4%
Dubai	2,821	4.4%
Oman	4,572	3.0%
Bahrain	1,311	1.6%

Source: Thomson Reuters Eikon, Marmore Research * As of 30-Jun-2018 ** Kuwait All Share Index

Part II. Cost of Debt

The cost of debt can be inferred easily as it entails specific cost in the form of interest payments made in cash. To compute the cost of debt, entire debt, including money market debt in the form of commercial papers/notes, bank debt in the form of loans/overdraft, financial leases and bonds raised is aggregated. The interest payments made as a proportion of interest bearing debt instruments provides us with the debt cost.

For instance, consider ABC Ltd., which has SAR 500mn in the form of long-term bonds and SAR 100mn in the form of bank loans. Annual interest payments include SAR 36mn and the tax rate for the firm is 5%.

Total Debt = Short-term Debt (money market/commercial papers/notes payable)

- + Long-term debt (bonds)
- + bank debt (loans/overdraft/working capital finance)
- + financial lease obligations

Thus, on a total debt of SAR 600mn ABC Ltd. pays an annual charge of SAR 36mn. From this, we can infer that the interest charged for ABC Ltd. 6%. As interest payments are tax deductible, we may find the after tax cost of debt as:

$$\begin{aligned} \text{Cost of Debt, after-tax} &= (\text{Interest charge incurred} / \text{Total Debt}) * (1 - \text{Tax rate}) \\ &= (36/600) * (1 - 0.05) \\ &= 5.7\% \end{aligned}$$

Part III. Cost of Capital

Having found out the cost of debt and cost of equity, we could compute the cost of capital as weighted average cost of capital as

$$\text{WACC} = (\text{Proportion of Debt} * \text{Cost of debt, after-tax}) + (\text{Proportion of Equity} * \text{Cost of Equity})$$

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Country wise Commentary

Country wise Commentary

Saudi Arabia

Risk-free rate for Saudi Arabia is estimated by adding sovereign risk premium for Saudi Arabia to the 10-yr US Treasury yield. There are multiple ways to compute the risk-free rate for a country.

Rf for KSA = 10-yr U.S T-Yield (2.85%) + KSA Sovereign Risk Premium (0.72%) = 3.57%

Saudi Arabia sovereign bond rating stands at A1 (Moody's) and A- (S&P ratings). Considering the U.S market equity risk premium of 5.4%⁵, the ERP for Saudi Arabia is arrived at by adding the default spread based on their credit rating. The implied ERP method provides a low equity risk premium for KSA market. The low ERP can be attributed to reflect the low market return expectations of the investors. On the contrary, ERP estimated using the credit rating and CDS spread methodology provides relatively higher ERP of 6.1% and 6.6% respectively. This is attributed to the inability of these methodologies to capture the prevailing positive investor sentiments towards equity instruments.

Kuwait

The risk free rate for Kuwait witnessed an increase, despite the sovereign risk premium remaining the same, predominantly due to the increase in the U.S risk free rate. Kuwait has managed to maintain its long-term credit rating of Aa2 since 2007.

Earlier, in order to compute the ERP, we took proxies from countries with rating similar to Kuwait due to the unavailability of a 10yr CDS. Now that we have the CDS spread for Kuwait, we have taken the actual values. Kuwait's ERP based on credit rating and CDS spread are 5.9% and 6.3% respectively, the implied ERP for Kuwait is 3.5%.

Qatar

Qatar witnessed no changes in its credit ratings since the last publication. Qatar witnessed an increase in the risk free from 3.02% at the end of H2 2017 to 3.47% at the end of H1 2018. Qatar's credit rating based ERP of (6.0%) and CDS based ERP of (6.6%) method increased by 30 bps each compared to H2 2017 values. The increase could be attributed to change in ERP of the US market as the 10yr CDS spread while the country's risk premium remained the same. The implied ERP of Qatar remained at 4.3%, unchanged from H2 2017 value.

UAE

As with the case of other GCC countries, Abu Dhabi witnessed an increase in risk-free rate due to the multiple hikes in US Fed rates during H1 2018 that triggered a rise in 10yr U.S Treasury yield. Dubai, with a higher CDS spread of 1.7% compared to Abu Dhabi's 1.0% had a higher ERP (CDS Method) of 6.8% while Abu Dhabi's ERP stood at 6.1%.

Oman

In March 2018, Moody's Investors Service lowered the long-term issuer and senior unsecured bond ratings of the government of Oman to Baa3 from Baa2. The agency cited that there was an absence of significant measures to narrow the fiscal and current account deficits, which would further weaken Oman's capacity to absorb potential shocks, as the reason for the downgrade. Oman whose rating is lower than that of KSA, Kuwait, Qatar and UAE has its ERP at 7.6% based on the credit rating methodology. Based on the CDS methodology, Oman's ERP is the second highest at 9.3%. However, the implied ERP stood at 3.0% for Oman. This low implied ERP could be attributed to the country's muted long-term growth outlook.

Bahrain

Bahrain's sovereign rating remained unchanged, as the ERP from ratings method increased to 10%, with the country risk premium remaining the same as that witnessed in H2, 2017. Bahrain overtook Oman as the GCC country having the highest ERP based on CDS methodology. This was primarily due to the rise in CDS spreads of Bahrain, taking the ERP to 9.5%. Cost of insuring Bahrain's sovereign debt against default were at high levels during June, 2018 as concerns over Bahrain's ability to wade off a potential financial crisis continued to persist. Bahrain's CDS spreads reached record highs during the month, similar to the levels witnessed in February 2016, when oil prices were at around USD 30 per barrel. The rise in CDS spreads were partly driven by a global sell-off in emerging market debt, while in Bahrain's case it was amplified due to the weakness in the government's finances. The implied ERP of Bahrain decreased to 1.6%.

Sovereign Ratings of GCC Countries, 2018

Country	Moody's Rating		S&P Ratings	
	H1 2018	H2 2017	H1 2018	H2 2017
KSA	A1	A1	A-	A-
Kuwait	Aa2	Aa2	AA	AA
Qatar	Aa3	Aa3	AA-	AA-
UAE	Aa2	Aa2	AA	AA
Oman	Baa3	Baa2	BB	BB
Bahrain	B1	B1	B+	B+

Source: Moody's, S&P

¹ Aswath Damodaran-1st Jan 2017

4 Final Note

Cost of capital in most of the GCC countries increased in H1 2018 due to the multiple hikes in US Fed rates during the period, which has pushed up the US 10-yr treasury yield. Most GCC countries have seen their CDS spreads widen during this period due to the sell-off of emerging market debt. Oman and Bahrain's sovereign credit ratings remained in the junk territory on the concerns that low oil prices have eroded the external reserves and debt exceeding the reserves in the future.

S&P Ratings of GCC Sovereigns

	Ratings	Kuwait	Qatar	UAE	KSA	Oman	Bahrain
Investment Grade	AAA						
	AA+						
	AA	Current		Current			
	AA-		Current				
	A+						
	A						
	A-				Current		
	BBB+						
	BBB						
	BBB-						
Junk	BB+						
	BB					Current	
	BB-						
	B+						Current

Source: S&P; Data as of Jun 2018

Adjusted CDS of GCC countries, H1 2018 vs H2 2017

Country	Adjusted CDS – H1 2018	Adjusted CDS – H2 2017
Oman	3.9%	3.5%
Bahrain	4.1%	3.0%
Dubai	1.4%	1.5%
Qatar	1.2%	1.2%
KSA	1.2%	1.1%
Kuwait	0.9%	0.7%
Abu Dhabi	0.8%	0.7%

Source: Reuters, Marmore Research

Adjusted CDS spreads of Bahrain, Oman and Kuwait witnessed a noticeable change in H1 2018. Kuwait's adjusted CDS was modified due to the availability of actual values, which was not the case in previous publications. Earlier, we used Abu Dhabi's 10-yr CDS spread as proxy for Kuwait as they had similar credit ratings. Bahrain witnessed the largest increase in the adjusted CDS spread, fuelled by the weakness in the country's finances.

Risk Free Rate, H1 2018 vs H2 2017

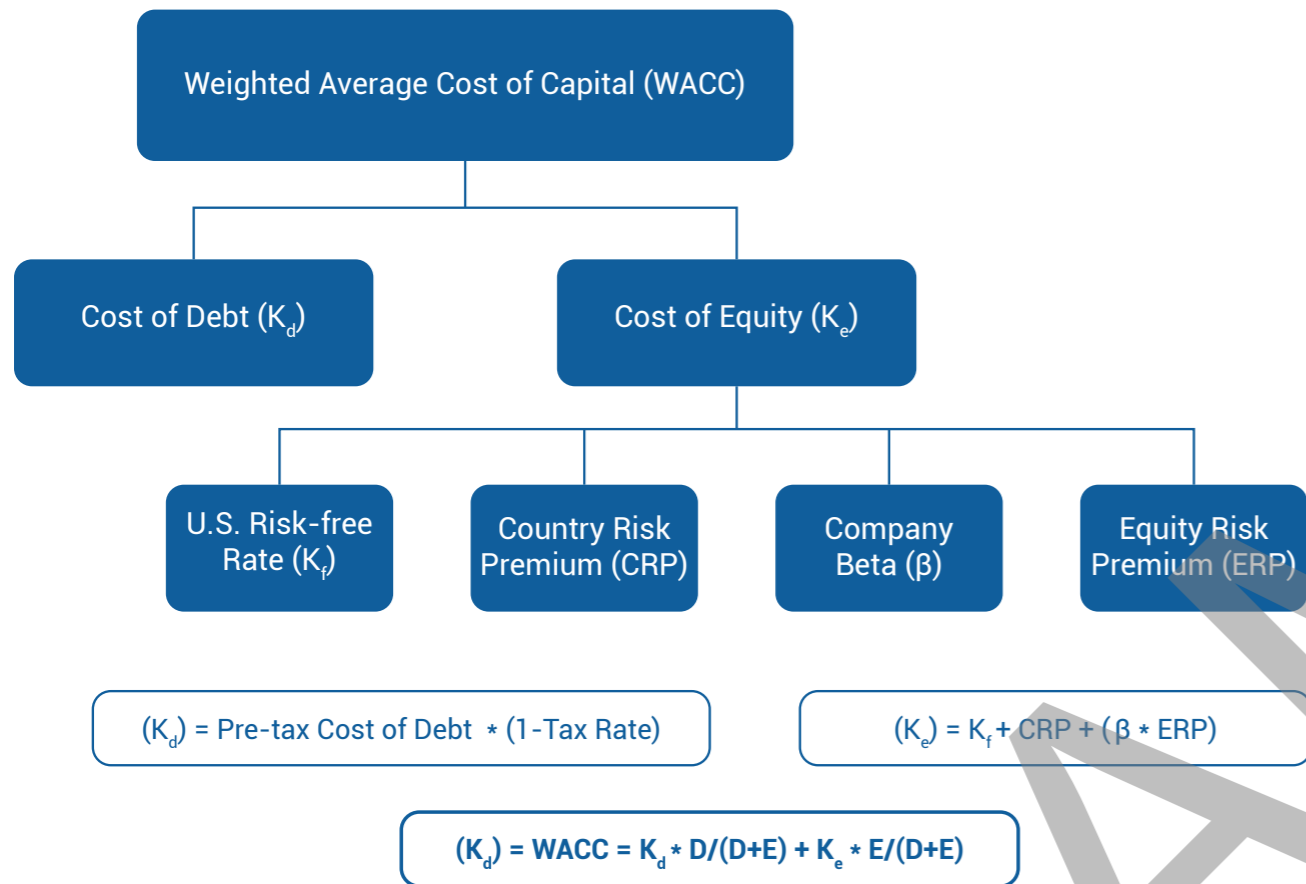
Country	H1 2018	H2 2017
Kuwait	3.36%	2.91%
Abu Dhabi	3.36%	2.91%
Qatar	3.47%	3.02%
KSA	3.57%	3.12%
Dubai	4.50%	2.91%
Oman	5.11%	4.35%
Bahrain	7.47%	7.02%

Source: Reuters, Marmore Research

As discussed earlier, the rise in US Fed rates during H1 2018 led to the increase of 10yr US treasury yield, which has consequently increased the risk free rates of all GCC countries. Oman was the only country whose sovereign risk premium witnessed an increase due to the revision of its long-term issuer ratings by Moody's to Baa3 from Baa2.

5 Appendix

The broad methodology of our computation could be illustrated as:



Source: Marmore Research; Note: 'D' stands for Debt and 'E' stands for Equity

Illustrative Example: Cost of Capital for a Private Firm

To illustrate this concept, we shall try to arrive at the cost of capital for a private cement company (ABC Ltd.) operating out of Saudi Arabia. Assume ABC Ltd has yearly revenues of SAR 4.5 billion and that the management has set a D/E target of 30%.

Comparable companies would then include the following list of companies:

Company	Revenues (FY 2015)	D/E	Beta (levered)
Saudi Cement Co	SAR 5.1bn	0.22	0.64
Southern Province Cement Co	SAR 5.4bn	0.23	0.48
Arabian Cement Co	SAR 4.3bn	0.11	0.89
Yanbu Cement	SAR 4.3bn	0.05	0.53
Average		0.15	0.36

Source: Reuters

From the levered beta, for ABC Ltd. comparable we arrive at the unlevered beta,

$$\text{Unlevered Beta} = \text{Levered Beta} / (1 + (1 - \text{tax rate}) (\text{Average D/E}))$$

$$= 0.36 / (1 + (1 - 0.05) (0.15))$$

$$= \mathbf{0.32}$$

This is levered according to the Debt-to-Equity ratio of ABC Ltd.

$$\text{Levered Beta} = \text{Unlevered Beta} * (1 + (1 - \text{tax rate}) * (\text{ABC Debt-to-Equity}))$$

$$= 0.32 * (1 + (1 - 0.05) * (0.3))$$

$$= \mathbf{0.36}$$

Considering this as the value of beta for the private firm, ABC Ltd. Its cost of equity is computed as below:

$$\text{Cost of Equity for ABC Ltd.} = R_f + \beta * (\text{KSA Equity Risk Premium})$$

$$= 2.49\% + (0.36 * 7.0\%)$$

$$= \mathbf{5.01\%}$$

Cost of Debt was computed earlier as 5.7%. With the values of cost of equity and cost of debt, we may arrive at the WACC

$$\text{Cost of Capital, WACC} = 0.3 * (5.7\%) + 0.7 * (5.01\%)$$

WACC, Cost of Capital for ABC Ltd. = 5.21%

Thus, the cost of capital for cement company ABC Ltd. with a capital structure of 30% debt and 70% equity in Saudi Arabia works out to be 5.21%.

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- Step 3: Project initiation
- Step 4: Fieldwork / research
- Step 5: Analysis & reporting
- Step 6: Review & approval
- Step 7: Report submission / presentation

