After the meltdown

FAISAL M SARKHOU LOOKS AT THE FINANCIAL CRISIS AND ITS IMPACT ON KUWAIT.

Following the financial meltdown seen across the world, the rules of financing business have changed. Kuwaiti companies are now adapting to these news rules as well as coping with factors that are specific to Kuwait.

The financial crisis has severely impacted the economic and financial conditions that Kuwaiti companies are now working under. As a result Kuwaiti companies are now focusing on restructuring themselves to deal with the changed business environment and, in particular, avoiding the threat of insolvency and/or bankruptcy. The government is increasing spending in the hope of stimulating the market and achieving a trickle down effect, and enhancing supervision and regulation in order to introduce and enforce the use of best international practices.

NEGATIVE IMPACTS When the crisis broke some local companies were forced to seek to sell assets to meet short-term obligations and large financing costs or consider declaring themselves insolvent and hence attempting to reschedule their debt with their creditors.

MARKET OVERVIEW Over the first nine months of 2010 credit facilities remained almost stagnant on the back of tight credit markets due to the banks being risk averse with material concerns over how the government's spending plan would be implemented. 2008 saw a decline in the growth of the money supply (M2) and credit owing to measures introduced by the Commercial Bank of Kuwait (CBK). In 2009 M2 grew by 13% to reach KD25bn but this was not matched by a significant growth in credit, with credit facilities losing momentum to grow by only 6% in 2009 to KD25bn. Sector analysis of Kuwait's banks' loan portfolios as at September 2010 showed personal finance at 34% of the total and real estate at 26% dominating the picture. A comparison of the change in credit facilities over the periods ending September 2009 and 2010 was even more interesting. To September 2009 personal finance credit had increased by KD421m and real estate by KD892m. A year later the increase in personal finance had fallen to only KD213m but real estate had gone into reverse, actually falling by KD107m.

The crisis had implications for both balance sheets and profit and loss accounts. Liabilities remained high while equity and assets fell significantly due to mark to market valuations and impairments. Profits were under severe pressure with either lower profits or losses in the investment sector. This sharp drop raised a key question about the quality and source of revenues prior to the financial crisis. It became clear that the majority of Kuwaiti companies relied heavily on gains from non-operating investments to boost their income, increasing their vulnerability and exposure to market fluctuations. This can be seen among real estate companies where out of a total revenue of KD2.34bn generated between 2003 and 2007, investment income represented 38%, KD910m. Equity investments held by real estate companies represented an average of 28% of the sector's total assets as of September 2009. The disturbances in the equity markets during 2008 and 2009 saw investment income and total income dropping sharply.

Another casualty of the global financial crisis was the Kuwait Stock Exchange (KSE), which since June 2008 has been hit hard. Total market capitalisation of the companies quoted on the KSE shrank by 45% to reach KD34.4bn as at 1 December 2010. The KAMCO TRW index fell by 38% with larger declines in the investment, banking and real estate sector. The investment sector shed KD8bn, 74% of its value, while the banking sector lost KD4.7bn and the real estate sector declined from KD 5.4bn to KD 3.6bn. Losses from the banking and investment sectors represented 45% of the total losses incurred by the market.

DEALING WITH FINANCIAL DISTRESS It is worth remembering how dramatically the picture has changed. From an abundance of equity/cash and easy access to cheap short-term debt financing, there has been a severe tightening of capital markets and lenders have changed the rules and conditions surrounding borrowing. Investors' wealth has been eroded: the era of highly liquid equity and real estate markets with strong growth and attractive future prospects has drawn to a close. All this has been accompanied by a fall in confidence in the financial systems, regulators and major market players.

The crisis also exposed weaknesses in Kuwait's economic structure and its lack of diversification. In the corporate sectors it has become apparent that companies increasingly invested in non-operational activities with a short-tem profit focus, giving little attention to having appropriate funding and capital structures and having in place weak financial and risk control measures.

One result of this financial distress has been the re-emergence of financial restructuring. Restructuring is designed to re-organise the legal, ownership, operational, financial and other structures of the company to boost profitability or to reflect the prevailing market conditions.

Such restructuring is needed in all sectors across the globe but often fails to happen or happens late because of the so-called change paradox of organisational inertia in the face of the need for change, senior management's inability to recognise or lead the necessary change and/or a failure in properly executing the change strategy.

Restructuring falls into two broad types. The first, financial restructuring, provides a one off short-term solution through the restructuring of funding, both debt and equity, and an absolute focus on meeting immediate cashflow needs. In contrast, corporate restructuring tries to find a more wholesome and permanent solution with an emphasis on long-term cashflow and an objective of working on the company's business plan and core activities, particularly looking at ongoing/quality revenue issues and a reduction of ongoing expenses.

Restructuring doesn't always work and once efforts have failed insolvency and bankruptcy prevails. Kuwait's corporate laws are not as comprehensive or business friendly as they should be with the existing bankruptcy laws – Law of Commerce 68/190 – not reflecting modern international corporate practices, rather it has a focus on enforcing payment of debt and provides no exit mechanism for insolvent entities. It must be noted, however, that bankruptcy has historically been a rare phenomenon in Kuwait and the region and hence the legal systems have limited experience and exposure to such cases. An important implication has been the diversity in insolvency and creditor rights between the different jurisdictions, which increases costs and acts as an impediment to inter-regional capital flows and foreign direct investment.

Box: Impact of the financial crisis on Kuwaiti companies

- Severe tightening of capital markets liquidity
- Heavy previous reliance on short-term funding
- Deterioration of value and liquidity of almost all asset classes
- Significant evidence of poor quality of earnings
- Erosion of investor wealth and confidence
- Poor levels of transparency and regulation.

GOVERNMENT RESPONSES The World Bank report *Doing Business 2010* (www.doingbusiness.org) sheds light on weakness in Kuwait laws, in terms of procedural and administrative bottlenecks. Improvements should be considered in areas such as regulation, judiciary, credit information and enforcement.

The government has taken a number of important initiatives in the last two years and more are planned in the future relating to:

- protection of the banking and financial systems;
- injecting liquidity into the capital market;
- encouraging lending to productive sectors of the economy;
- regulatory and supervisory reform;
- increased planned government spending; and
- privatisation initiatives.

The key government responses to combat the effect of the financial crisis on Kuwait's private sector are:

- guarantee of bank deposit – October 2008;
- capital market support (investment injection) – Q4 2008;
- financial stability law – March 2009 and Capital Markets Authority law – February 2010;
- relaxation of credit and provision of liquidity to banks – H1 2009;
- issuing treasury bonds to absorb excess liquidity – 2009;
- KD30bn four-year development plan – February 2010; and
- Pprivatisation law – H1 2010.

KEY LESSONS Kuwaiti businesses are now aiming to avoid practices which precipitated the financial crisis – excessive financial leverage, high exposure to non-core equity investments, relying on unrealised profits, deviation from core business activities and maturity mismatches. At the same time the episode illustrated the need for better and broader financial regulation and supervision, regulation reforms and the formation of the Capital Market Authority. In the future we can also look forward to more prudent behaviour from both financial institutions and businesses.

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