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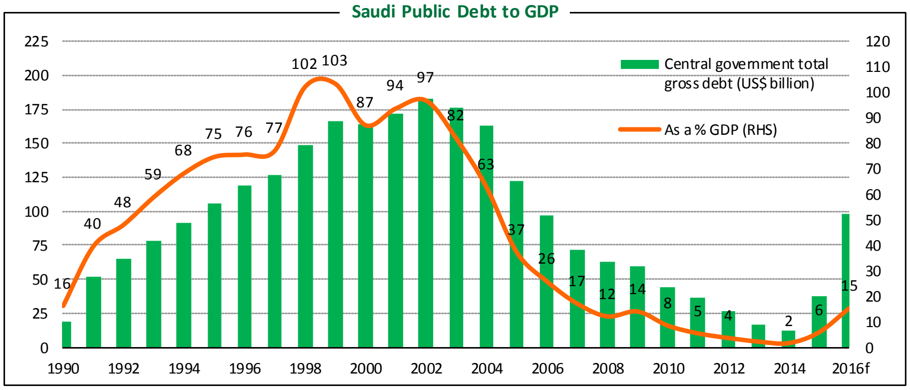
Saudi Arabia: Is debt the answer to the Kingdom's conundrum?

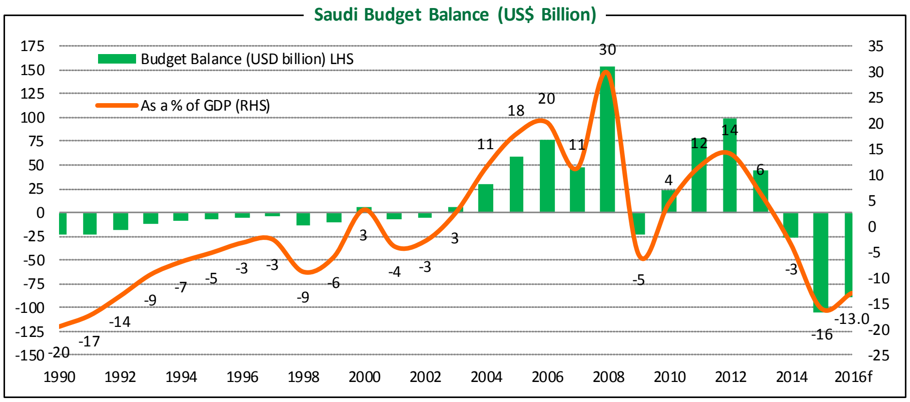
So the waiting is over. Saudi Arabia's much anticipated, much hyped, and arguably much needed, super-jumbo debt issuance is almost here. Last week we saw the mandate publicly announced, and it seems that notwithstanding any black swan events or adverse market conditions, the deal could be printed this week. There was some speculation in the media about KSA's motives behind the deal and how they could be trying to surpass the size of Qatar's largest bond issue. Let's be clear about this, one-upmanship or not, the bottom line is that Saudi Arabia simply needs the cash as part of its attempt to deal with the substantial budget deficit. In this context the fact that the expectation is for a $15-$20bn deal is positive. The indication that it may be done across 5, 10 and 30 year tenors is reassuring too, as it shows us that the Kingdom is thinking longer term with this deal.

A firmer oil price and the continued strong demand from institutional investors across the globe for high quality paper offering some yield, are perhaps two good omens ahead of the Kingdom's first foray into the international bond market. Along with the successful conclusion of a US$10 bio bank loan recently, this illustrates that the Saudi leadership have decided that external borrowing will indeed be a key part of the solution to addressing its fiscal deficit, and stemming the sharp deterioration of its reserves. Bear in mind though that given the magnitude of the deficit and indeed Saudi's fiscal challenge in general, borrowing cannot be the solution in itself. Loans and bonds can certainly be a material part of the solution, but the Kingdom will also have to use various other tools available to it, and possibly need to pull a rabbit or two out of the hat as well.

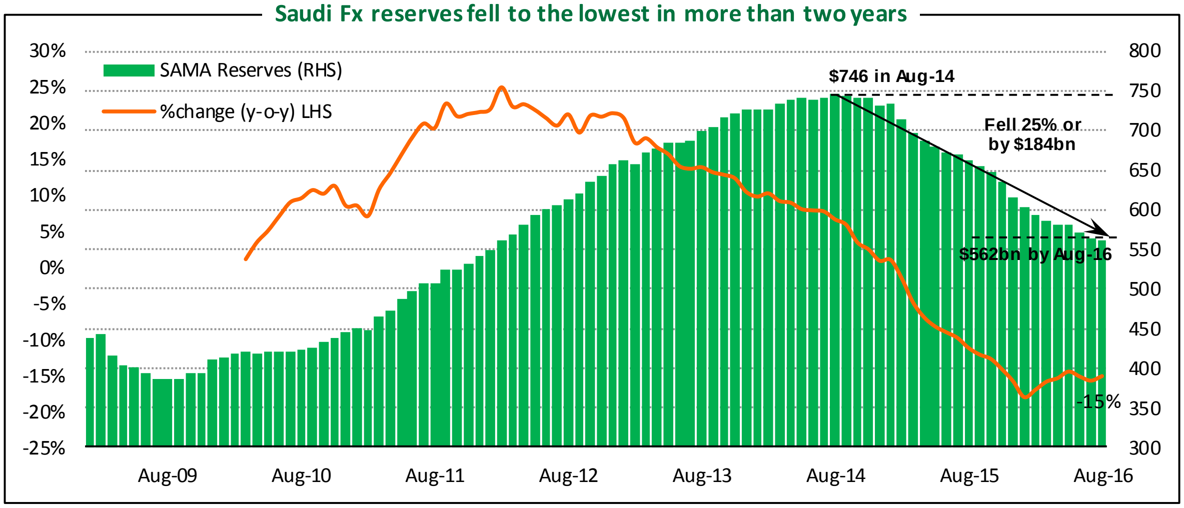


Source: SAMA; NBAD

Interestingly this debut bond's prospectus contains government expectations of a reduction in capital spending by more than 70% this year compared to 2015, which combined with recently implemented subsidy and public sector salary cuts highlights the country's ongoing commitment to rein in costs in order to meet its budget deficit target of 13.50% in 2016 against 15% last year.



Source: SAMA; NBAD



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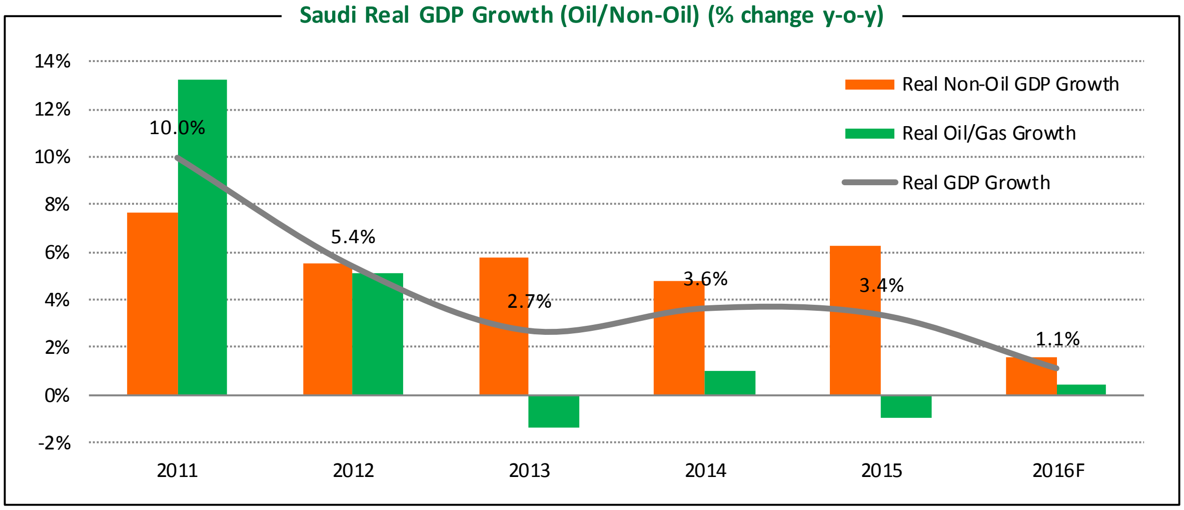


Source: SAMA; NBAD

Apart from tightening expenditure some initial progress has also been made in other areas linked to the Kingdom's ambitious 'National Transformation Plan,' including the following:

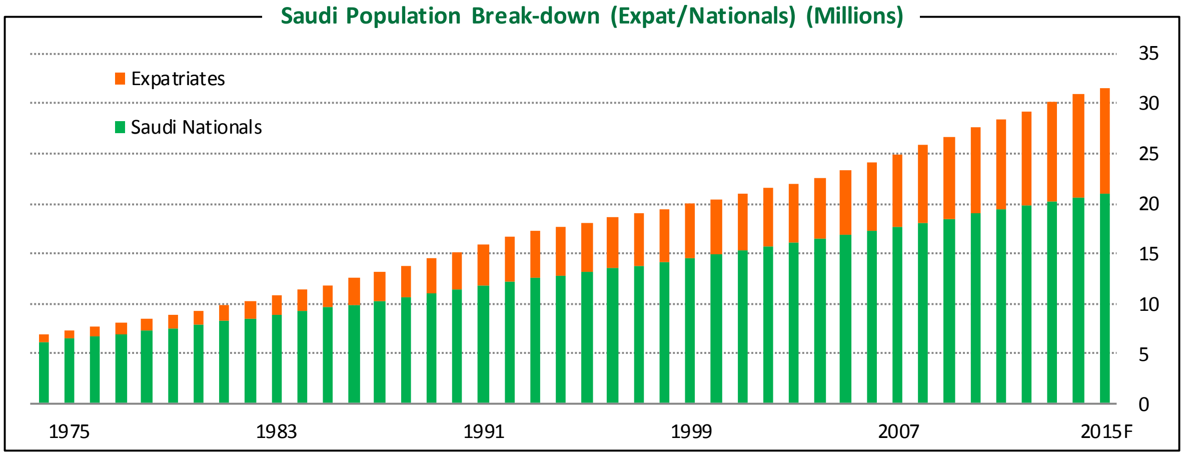
- A major cabinet reshuffle and new appointments within key posts.
- The consolidation and streamlining of government ministries.
- A hike in the cost of government fees, visas and traffic fines as well as the recent official greenlight for the introduction of a 2.5% tax on undeveloped urban land.
- The Capital Markets Authority completion of a draft proposal to relax current restrictions on foreign ownership, widen the categories of QFIs and raise the limit on number of shares they can own in a single company. These proposals are expected to be fast-tracked and follow on from the CMA's decision last year to give offshore investors direct access to its stock market, the region's largest.
- The news that SAMA is currently considering easing some of the restrictions on activities engaged in by foreign banks in the country, such as allowing them to open more branches and offer business loans and mortgage products. The number of licenses may also be increased.
- Saudi Arabia joining a regional committee working on the implementation of a GCC wide value-added-tax.

Meanwhile the more substantial changes outlined within the NTP are still to come namely:

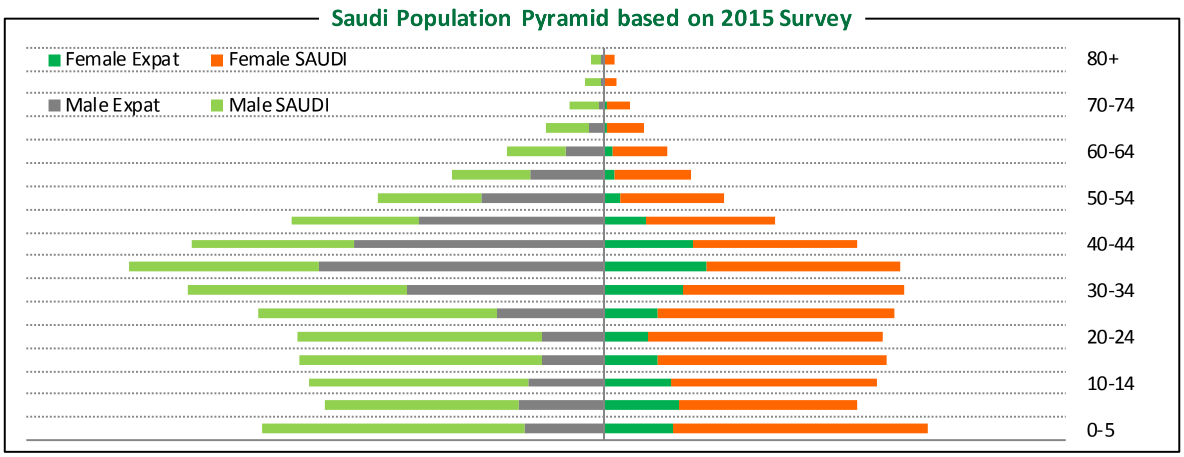
- The Saudi Aramco IPO and creation of the world's largest sovereign wealth fund.
- Increased focus on SME's and a diversification of exports.
- Creation of a domestic arms industry.
- Expansion of the mining sector.
- Establishment of 'special' economic zones.
- Educational reforms with a focus on technology.
- Increase the number of women in the workforce.
- Develop both religious and conventional tourism.

The road towards weaning Saudi Arabia off its over-dependence on oil revenues will be a long and difficult one, but no matter where the crude price may be heading these changes have to be enacted sooner rather than later. The country's total population is forecast to hit 39 mio by 2030, but Saudis currently only constitute around 35% of the overall workforce with the bulk of these employed within the higher paying public sector. This combined with a demographic picture showing that more than 50% of the local population are under the age of 25, underlines the urgent need for major labour and educational reforms. Certain mindsets will also need to be changed, government posts can no longer be guaranteed and so new Saudi job-seekers will in future have to look at the private sector for opportunities.

In the interim however we continue to believe that the Kingdom has enough tools at its disposal to weather its immediate fiscal challenges. Pulling off a super-duper sized bond issue this week would certainly help.



Source: Saudi Statistical Authority; NBAD



Source: Saudi Statistical Authority; NBAD

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