Saudi Arabia – The Kingdom Strikes Back

Following the recent onslaught of negative headlines and commentary in the media about Saudi Arabia's financial situation, allegations about the sovereign having its back against the wall, and general bearishness in terms of sentiment, the Kingdom seems to be fighting back with some punches of its own. What the Kingdom of Saudi Arabia (KSA) leadership are saying isn't ground-breaking news per se, however – as we have been suggesting for some time now – they are emphasising the fact that the country does indeed have options available to it, with which it will be able to get through the current challenges.

In this report, we discuss some of the key matters in the Saudi story as we see them: SAMA's rapidly depleting reserves, the strength of the banking sector, recent rating actions on Saudi banks by S&P, headlines about proposed debut bond issuance by the Sovereign, listing of a minority stake in Aramco and the formation of a new Sovereign Wealth Fund which will use its substantial assets to generate returns and ultimately provide a more sustainable revenue stream for the Government beyond oil, etc are all key components. However, this is not a finite list and there will be additional items that come up as the story continues to evolve.

If, as announced, the Government does indeed list a minority stake in Aramco it will certainly put a number on the true value of one of the country's crown jewels. Irrespective of what the number may eventually be, it will be impressive for sure. But let's just take a moment to think about this. An impressive valuation of Aramco doesn't in itself solve the country's current financial problems – ultimately the valuation may be a great but it doesn't automatically result in an equally impressive figure being generated in terms of incremental cash. In our view the asset base of KSA isn't up for debate, it is substantial and one of the highest in the world. However, much like the Dubai debt crisis in 2009, Saudi's current predicament isn't due to a lack of good assets but rather it is a matter of cash flow. The steep decline in KSA's revenues due to the oil price, the significant ongoing costs and cash outflows, and indeed the war in Yemen, are all contributing to the budget deficit. Ultimately this is a cash flow issue and any proposed solutions need to take this into consideration. Getting a stellar valuation on Aramco, even if only a small stake is ultimately listed, will bring other benefits. For one, the valuation will make it easier for the Government to borrow from banks and capital markets once it shows the extent of its asset base. Second, it will quantify the amount of cash that KSA could generate in future through listing of additional stakes in Aramco, if needed – something that will provide a degree of comfort to investors and market participants even if it doesn't materialise. The very existence of this option carries intrinsic value and will help to calm nerves.

Bottom line, Saudi Arabia has substantial assets, financial reserves, and a whole host of options in its 'tool kit'. Together, these will, in our opinion, enable the nation to work its way through the current predicament. For sure, some of the options that the Government has will not be easy pills to swallow, and the implementation of any reforms will not be without its own challenges, but overall we believe the Kingdom certainly has the strength to get through this. Watch this space…

06 April 2016

Chavan Bhogaita
Head of Market Insights & Strategy

Glenn Wepener
Executive Director

Alp Eke
Senior Economist

Rakesh Sahu
Analyst

From Oil Company to Sovereign Wealth Fund…

In 1933 the Saudi Arabian government granted Standard Oil of the US a concession to search for oil in the Kingdom. Five years later the first discovery was made and by 1944 the oil was being pumped and sold by a consortium called the Arabian American Oil Company (Aramco). Over time the government acquired a series of stakes in the firm eventually gaining full control in 1980. Seven years on the company was renamed the Saudi Arabian Oil Company (Saudi Aramco), and since then its operations have expanded globally, from the exploration and production of oil and gas to include refining, distribution, and the manufacture of chemicals. Although state-owned the company has essentially managed itself, and is considered to be the largest and most successful energy firm in the world. However, the sharp drop in oil revenues and the subsequent need for the country to diversify its economy away from crude has led King Salman's administration to look closely at this "crown jewel" and find ways to leverage on its tremendous assets to help restructure the economy for the future.

Thus in January this year Saudi Arabia's energetic Deputy Crown Prince, Mohammed bin Salman, announced a proposal to list a portion of Saudi Aramco on the local stock market. Last week the Prince re-affirmed his government's decision to move ahead with such an IPO suggesting that a listing could take place within a year, and would be for as much as 5% of the entire firm, rather than just some of its downstream assets as originally expected by analysts. The rest of Aramco would remain under state ownership but controlled via the Public Investment Fund, which could eventually become the largest sovereign wealth fund in the world. "The mother company will be offered to the public as well as a number of its subsidiaries," Prince Salman, who also chairs Saudi Aramco's Supreme Council, stated adding that his government wanted the firm to become an energy related industrial giant, rather than just an oil and gas company. Discussion over the actual value of Aramco has been debated for years, however considering its vast oil reserves and using a very conservative estimate based on an oil price of just US$10 per barrel it works out close to US$2.5 trillion, making it potentially the world's most valuable company.

Deep Pockets…

Saudi Arabia forecasts a deficit of SAR 326bn ($87bn) for the current financial year, while the country's official FX reserves dropped by 17% year-on-year to reach $593bn at the end of February 2016. Both of these issues demand attention and with oil prices likely to remain constrained in the near to medium term it's crucial that the government follows through with plans for the introduction of VAT and a reduction in subsidies, combined with the implementation of other key reforms such as those expected to be listed in its soon to be unveiled 2020 Strategy which will focus on; job creation, attracting investment into non-oil opportunities (like the country's still untapped mining sector), as well as an improvement in the accountability and efficiency of government departments. In the interim period however we believe the country has more than enough resources to manage its fiscal position, it's worth noting that the Kingdom has plenty of experience in handling a drop in oil revenues having run up sizeable deficits between 1983 and 1999. Saudi Arabia's government is currently also in the fortunate position of having a very low debt to GDP ratio of 6% (compared to 100% in 1999) and thus we expect a continuation of its program of domestic bond issues and foreign bank borrowing, followed up by the tapping of the international debt market via a US dollar bond before the end of this year in order to help finance the budget.

Recent rating actions…

Rating agencies Standard & Poor's and Moody's have taken a raft of negative rating actions on the Kingdom and its entities over the past two months citing adverse economic impact from low oil prices. After all oil & gas accounts around 84% of its export and contribute circa 40% of GDP. The first rating action this year came from S&P in February when it downgraded KSA's sovereign credit rating by two notches to 'A-' from A+, concluding its negative outlook initiated last year October when it downgraded the Kingdom's rating to A+ – the first ever downgrade since S&P started rating Saudi Arabia. This is indeed the most punitive rating action on the Kingdom thus far owing to low oil prices and its impact on Saudi economy. The February downgrade was based on S&P's conclusion that Brent oil prices will average $40 a barrel in 2016 but the Kingdom's 2016 budget assumptions are based on oil trading at $45 a barrel. "The decline in oil prices will have a marked and lasting impact on Saudi Arabia's fiscal and economic indicators given its high dependence on oil," S&P said in a statement.

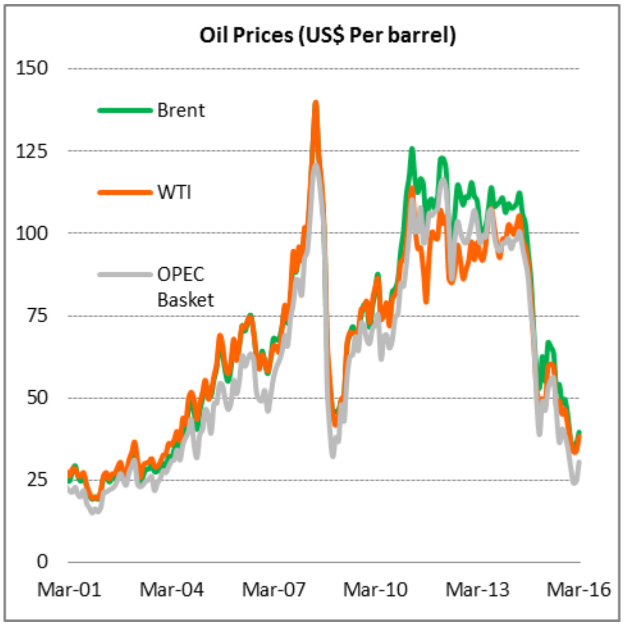
Subsequently, Moody's on 4th March put the Kingdom's 'Aa3' rating on review for a possible downgrade echoing similar views from S&P. Moody's assumes that Brent oil price will average $33 per barrel in 2016 and $38/bbl in 2017, rising only slowly thereafter to $48 by 2019. Moody's thus wants to assess the extent of economic impact on Saudi Arabia of any further sharp fall in oil prices to conclude its rating review. Moody's expects to conclude its review by end of May and we expect that the agency will cut Saudi rating by one notch to A+. S&P's stable outlook on the Kingdom's revised ratings however shows limited downside risk at the moment. Following their respective rating actions on the Saudi sovereign, S&P and Moody's have also taken several negative rating actions of on the Saudi banking industry and selective government related corporate entities. *The table on the last page provides a comprehensive overview on the rating actions taken by these two agencies.*

Both Moody's and S&P have a negative outlook on Saudi banking system driven by the downside impact of low oil prices on Saudi economy. While S&P said that the credit conditions for Saudi banks will deteriorate through a correction cycle, Moody's expects that the declining government spending, owing to low oil prices, will ultimately weigh on the Saudi banking sector as its operating environment will weaken over the next 12-18 months. Both S&P and Moody's believe that non-performing loans will increase leading to credit losses for the banks. Nevertheless, the Saudi banking sector, in our opinion, is resilient to weather these downside risks as the banks are still profitable and are well capitalised to absorb any economic shocks.

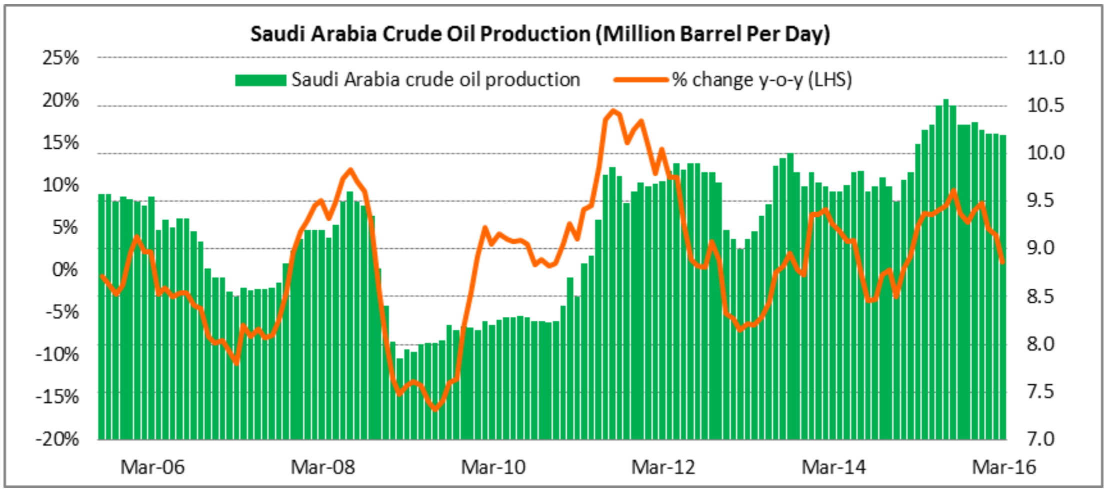
In the below section we have provided a brief overview on the oil market and its impact thus far on Saudi economy and its banking sector.

Oil Production Levels Likely To Remain High

While we may well have already seen the low in oil prices we don't expect a sharp rise either for the time being. We also believe whether a "freeze" agreement is reached at the producer meeting in Doha later this month or not, the KSA will continue to pump crude at its recent high levels in order to maintain market share. Further out the picture is less clear because despite the current glut and weak global economic growth the IEA forecasts overall demand to continue to grow, this fact combined with the ongoing and substantial drop in Capex in oil sector, infrastructure and legal hurdles holding back Iran's full return to the market, as well as signs the US shale "revolution" has peaked opens up the risk of a sizeable spike in prices in 2-3 years' time.



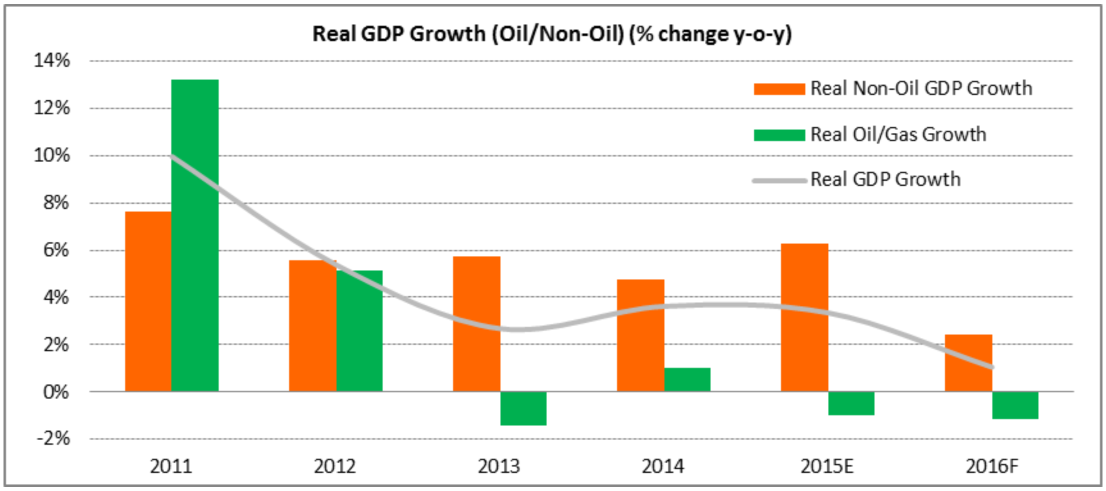
Source: NBAD



Source: NBAD

GDP Growth Set To Slow In 2016

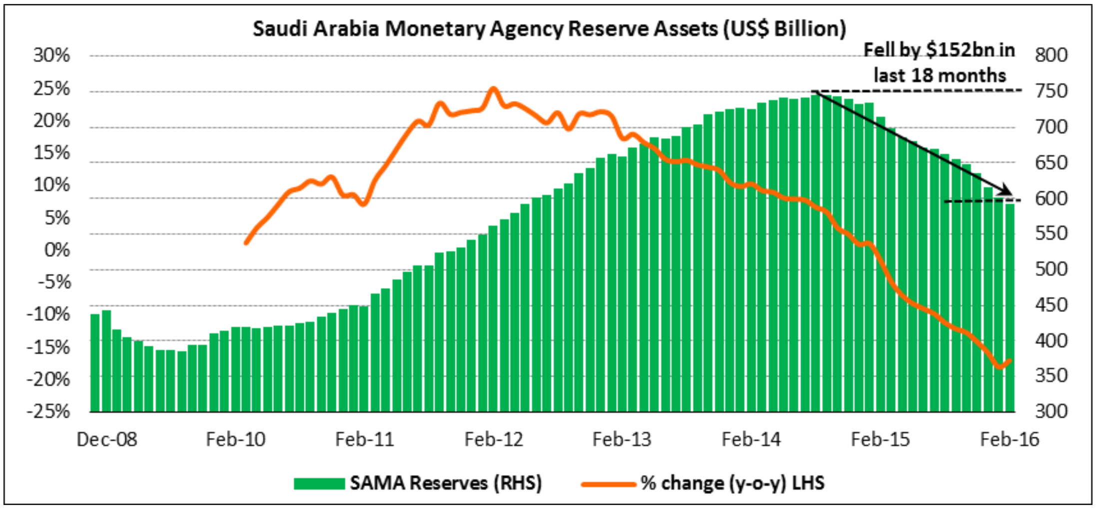
The Kingdom's GDP growth is expected to slow in 2016 on account of lower spending and the liquidity squeeze the banking sector is facing on account of lower oil revenues. Non-oil economic activity in 2015 was supported by the government's expansionary development spending and stimulus packages targeting education, health, housing and infrastructure. The new labour regulations, passed in 2014, aimed at restricting expatriate employment were also implemented in 2015 benefiting consumer spending and improving business sentiment. However, following the sharp decline in oil prices the government announced an austerity program in December 2015 which has resulted in reduced public spending and thus impacting business sentiment. We now estimate that while non-oil activity will expand by around 2.5% in 2016, this growth will be offset by a 1% contraction in the oil sector resulting in overall GDP growth of 1.5%.



Source: NBAD

SAMA's Reserves Fall

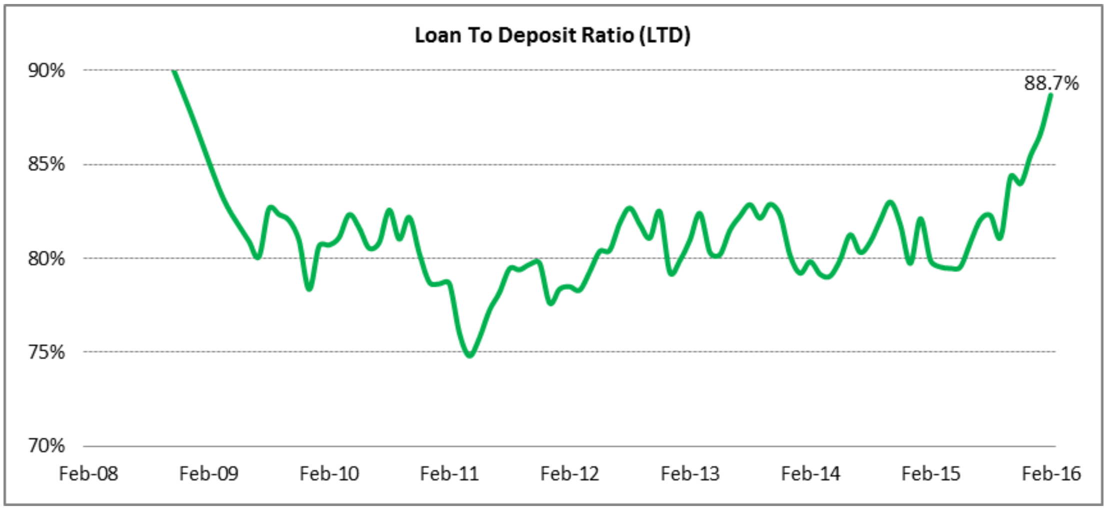
Reserves at SAMA, the Saudi central bank, have dipped sharply as the Kingdom continues to drawdown in order to fund public spending. Reserves peaked in August 2014 at a record $745bn, third highest in the world and almost half of Japan's FX reserves, as average oil prices sat above $100 from 2011 through to July 2014. However, the subsequent drop in oil revenues coupled with increased government expenditure led to a substantial decline in reserves. From its peak to February 2016, reserves have declined by $152bn and now stand at $592.7bn.



Source: NBAD

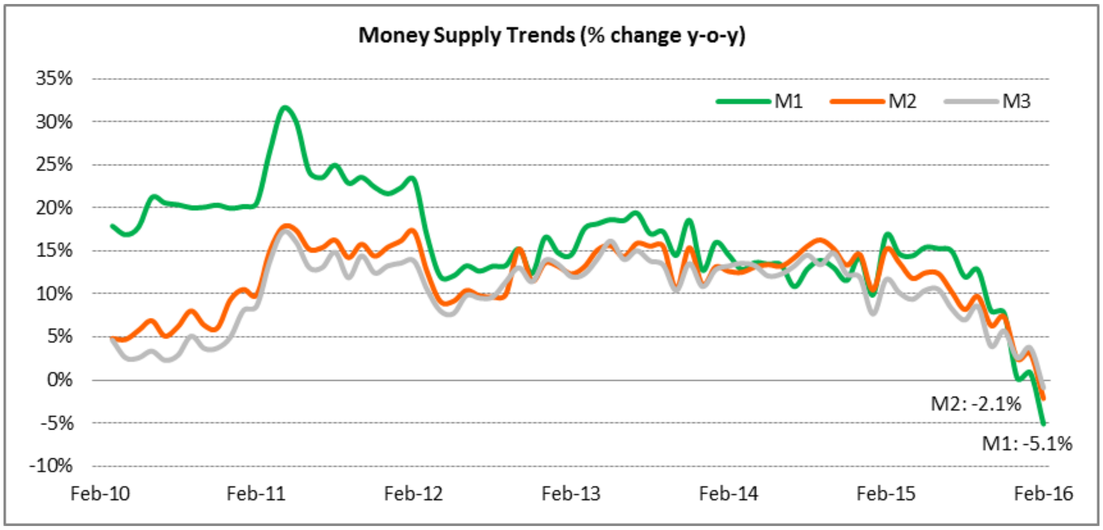
Money & Credit (Deposits)

Lending by commercial banks is on an upward trend and has reached record levels. LTD ratio reached an 8 year high (88.7%). SAMA thus recently re-adjusted the LTD ceiling to 90% from a previous 85% ceiling. Nevertheless, the Saudi banking sector is highly liquid and is indeed ready to meet increased demand for loans. In 2012, a new mortgage law was approved by the government, where property will be secured as collateral. This had a positive impact on the quality and security of mortgage loans. Previously, housing loans were secured against salaries.



Source: NBAD

The increased lending to the private sector along with a slow-down in deposits had a knock-on effect on liquidity as the LTD ratio increased. As a result most banks started using interbank lending to have access to liquidity. In February 2016, all the money supply indicators declined for the first time since 1994, primarily due to a decline in demand deposits. The narrow measure of money (M1) declined to $306.4bn (-5.1% y-o-y). M2 declined to $416.3bn (-2.1% y-o-y) and & M3 declined to $ 467.4bn.



Source: NBAD

Notes: *Money Supply (M1):* Consists of currency in circulation outside banks plus monetary deposits in local currency with banks (all short-term deposits on which bank customer can withdraw without prior notice);
Money Supply (M2): Consists of Money Supply (M1) plus quasi-monetary deposits (Resident Time and Savings Deposits in Dirham + Commercial Pre-payments in Dirham + Resident Deposits in foreign currencies);
Money Supply (M3): Consists of Money Supply (M2) plus Government deposits

Market Insights & Strategy
Global Markets
National Bank of Abu Dhabi
Tel: +971 2 6110 127

Click here to go back to the rating discussion on page 3

	S&P rating	S&P Outlook	S&P's latest comment	Moody's rating	Moody's Outlook	Moody's latest comment
Kingdom of Saudi Arabia	**A-**	**Stable**	S&P on 17th Feb cut KSA's rating by two noctes to A- citing "marked and lasting" impact of the rout in oil prices. S&P said it has cut its assumptions about oil prices for 2016 to 2019 by about $20 a barrel, with Brent expected to average $40 a barrel in 2016 and gradually rising to $50 a barrel by 2018. S&P expects Saudi government debt burden to exceed 7% of GDP between 2016 and 2019. The stable outlook on the rating reflects S&P's expectations that Saudi authorities will take steps to prevent any further deterioration in the government's fiscal position beyond the agency's current expectations. According to S&P, sovereign debt burden could exceed 7% of gross domestic product between 2016 and 2019.	**Aa3**	**Watch -ve**	Moody's put Saudi Arabia's rating on review for downgrade on March 4 saying that it will assess the extent of the impact of the further sharp fall in oil prices, which Moody's expects to remain low for several years, on Saudi Arabia's economic performance, its government balance sheet, and its balance of payments in the coming years. According to Moody's oil and gas account for over 84% of exports and roughly 40% of GDP. They also provide around 62% of consolidated government revenues. Thus Moody's said the structural shock to the oil market is weakening Saudi Arabia's government balance sheet, its economy, and therefore also its credit profile. Moody's revised its oil price assumptions for Brent to $33 per barrel in 2016 and $38 per barrel in 2017, rising only slowly thereafter to $48 by 2019. As a result, Moody's now expects KSA's current account deficit to widen to around 12% of GDP this year, driven by a further decline in oil exports and slower growth in non-oil exports due to dampened global demand.
Saudi banking industry	According to S&P, Saudi banks face increased economic risks, owing to the drop in oil prices and the resulting slowdown in the Saudi economy. S&P said credit conditions for Saudi banks will deteriorate through a correction cycle, leading to increased nonperforming loans and credit losses, as well as declining profitability. As a result S&P has revised its Banking Industry Country Risk Assessment (BICRA) on Saudi Arabia to group '4' from group '3', on a scale of '1' to '10', with group '10' indicating the highest-risk banking systems.			On 16 March Moody's changed its outlook for the Saudi banking system to negative from stable saying the revised outlook reflects its expectation that the persistently low oil prices and resultant government spending declines will ultimately weigh on the Saudi banking sector. Moody's expects the banking sector operating environment to weaken over the next 12-18 months and said non-performing loans will increase to around 2.5% of total loans over this horizon, from a very low average 1.4% in Sept. 2015. However, it added that capital buffers are likely to remain solid.		
National Commercial Bank	BBB+	Stable	Ratings of NCB, SABB, Riyad Bank, Al Rajhi and Samba cut by one notch on 31 March as S&P believes that these banks now face higher economic risks due to the drop in oil prices and the ensuing slowdown in the Saudi economy. S&P now assess the anchor, its starting point, for these banks at 'bbb' versus 'bbb+' previously.	A1	Watch -ve	As a result of its negative outlook on Saudi banking system, Moody's changed the outlook on Saudi bank to negative from stable. "With the prospect of lower oil prices for longer and a 14% reduction in public spending in 2016, we believe that the credit risks across the system are rising," Moody's said in a statement. Moody's expect Saudi loan growth to deteriorate between 3% and 5% in 2016 from 8% in 2015 and 12% in 2014. The rating agency will conclude the rating review following the conclusion on the sovereign.
Saudi British Bank	BBB+	Stable		Aa3	Watch -ve	
Riyad Bank	BBB+	Stable		A1	Watch -ve	
Al Rajhi Bank	BBB+	Stable		A1	Watch -ve	
Samba Financial Group	BBB+	Stable		Aa3	Watch -ve	
Banque Saudi Fransi	BBB+	Stable	On 31st March, S&P affirmed ratings of BSF & ANB at 'BBB+' and SIB's at 'BBB'. The affirmation reflects S&P's view that the weakening of the bank's stand-alone credit profile (SACP) is mitigated by the expectation of a high likelihood of extraordinary support from the Saudi government to the bank if needed.	Aa3	Watch -ve	
Arab National Bank	BBB+	Stable		A1	Watch -ve	
Saudi Investment Bank	BBB	Stable		A2	Watch -ve	
Saudi GREs						
Saudi Electricity Co	A-	Stable	Following the sovereign downgrade on 18 March, S&P on 22nd March cut the ratings of Seco, Sabic and Saudi Telecom by two notches each saying it has aligned the ratings with the sovereign given their strong links with the Saudi government.	A1	Watch -ve	On 8th March Moody's put the ratings of these entities on review for downgrade saying it will assess the credit implications from the (1) conclusion of the review for downgrade on the sovereign; (2) the govt's support & dependence assumptions; & (3) the impact of a weakening economic environment on their baseline credit assessments (BCAs).
Saudi Basic Industries Corp	A-	Stable		A1	Watch -ve	
Saudi Telecom Co	A-	Stable		A1	Watch -ve	