MARMORE
MENA INTELLIGENCE

Saudi Arabia

Top Economic & Investment Themes for 2016

Classification of economic and investment themes for the Kingdom of Saudi Arabia financial markets.

www.emarmore.com
info@e-marmore.com

January 2016

Top Economic & Investment Themes for 2016

Saudi Arabia

Research Highlights:
Analysis of key economic and investment themes for Saudi Arabia in 2016

Markaz Research is available on
Bloomberg - Type "MRKZ" <Go>
Thomson Research,
Reuters Knowledge
Nooz
Zawya Markets
ISI Emerging markets
Capital IQ
FactSet Research Connect
TheMarkets.com

M.R. Raghu CFA, FRM
Head of Research
+965 2224 8280
RMandagolathur@markaz.com

N.C. Karthik Ramesh
Manager - Research
+965 2224 8000 Ext: 4611
KRamesh@markaz.com

Irfan Ahmed Naheem
Analyst
+965 224 8000 Ext : 4607
INaheem@markaz.com

Kuwait Financial Centre K.P.S.C. "Markaz"

P.O. Box 23444, Safat 13095, Kuwait
Tel: +965 2224 8000
Fax: +965 2242 5828
markaz.com

Economic Summary

Key Themes	Rationale	Stock Market	Bonds	Real Estate	SME
Energy Prices Reform	Significantly declining revenues and higher fiscal deficit resulting in Government revisiting it's generous energy subsidy policies				
KSA Currency Peg	Depleting fiscal reserves is exerting pressure on its currency as evidenced by investors activity in forward swap markets				
Labor Law Reforms	The labor laws reforms (Nitaqat) adopted by KSA can have significant economic implications				
Local Debt Market Development	The development of local debt markets has become imperative to maintain sufficient liquidity and alleviate funding pressures in the domestic banking system		NA		
Foreign Investment Reforms	KSA Government has implemented reforms to allow 100% foreign investment in retail sector and permitted foreign institutional investor's participation in KSA's stock exchange				

Source: Marmore; Legend for color codes: Positive Impact | Neutral Impact | Negative Impact

The significant decline in oil prices and subsequent drop in revenues for the Kingdom of Saudi Arabia (KSA) calls for tighter fiscal consolidation. Moreover, the continued lower oil prices require KSA to consider alternative revenue streams and funding sources, such as taxes and debt from local and international markets to meet its fiscal expenditure.

KSA has been home to several perks such as lower energy prices, food & water subsidies and absence of taxes for individuals and domestic corporations. subsidized energy prices translate into significant costs for the government, estimated at USD 107bn or 13.2% of the gross domestic product in 2015[1]. However, the low oil price environment calls for prudent assessment and reforms in these subsidies to achieve sustainability of government finances on a long-term basis. KSA has significant reserves to be self sufficient in the short-to-medium-term. However, KSA could exhaust its financial reserves in less than 5 years unless the government curbs unnecessary expenditure and raises other streams of revenue. The low oil price enviroment and the fast depleting reserves is exerting significant pressure on the SAR-USD peg which is reflected in the currency forward markets.

[1] IMF estimates – Financial Times

Theme 1: Energy Price Reform

In comparison to the international standards, energy prices are low in the GCC countries. Low energy prices have existed parallel to the economic development over the last five decades. However, the cost of the energy subsidy has risen immensely due to demographic growth and increased levels of per capita energy consumption. The drop in oil prices has made evident the need for fiscal consolidation and in the process the energy price reform is inevitable. Now that the GCC Governments are considering reforms, there exist a number of challenges such as social discontent, impact of higher energy prices on low income households, inflation and future growth.

KSA leads the group in terms of cheapest gasoline and diesel prices amongst the GCC countries.

Current Energy Prices

The energy prices in most of the GCC countries are considerably lower than the international prices. There is significant difference in pricing amongst the GCC countries itself. However, KSA leads the group in terms of cheapest gasoline and diesel prices amongst the GCC countries. The price of gasoline is almost c.74% cheaper than the pre-tax price in the US and c.76% cheaper than the price in UAE, which has the highest price for gasoline amongst the GCC countries. The same low price trend continues for diesel as well which is c.91% cheaper in KSA compared to US and c.89% cheaper than the price in UAE.

The price of natural gas in KSA is on par with UAE and Qatar. However, it is still significantly cheaper compared to the price in the US and Oman i.e. the highest price market for natural gas in the GCC region. Electricity is the only energy product for which the price charged in KSA is the highest amongst the GCC countries except UAE, yet it is marginally lower to the price in the US.

Prices for Energy Products: GCC and the USA (Jan – Aug, 2015)

Country	Gasoline	Diesel	Natural Gas	Electricity
	US dollars per liter		USD per MMBtu	US dollars per KWh
Bahrain	0.27	0.27	2.50	0.03
Kuwait	0.24	0.39	1.50	0.01
Oman	0.31	0.38	3.00	0.04
Qatar	0.27	0.27	0.75	0.05
Saudi Arabia	0.14	0.06	0.75	0.09
UAE	0.59	0.56	0.75	0.10
USA (Pre-Tax)	0.53	0.64	2.80	0.10

Source: IMF

The estimated cost of energy subsidies for KSA was USD 107bn or 13.2% of the gross domestic product in 2015.

Budget Costs and increased consumption

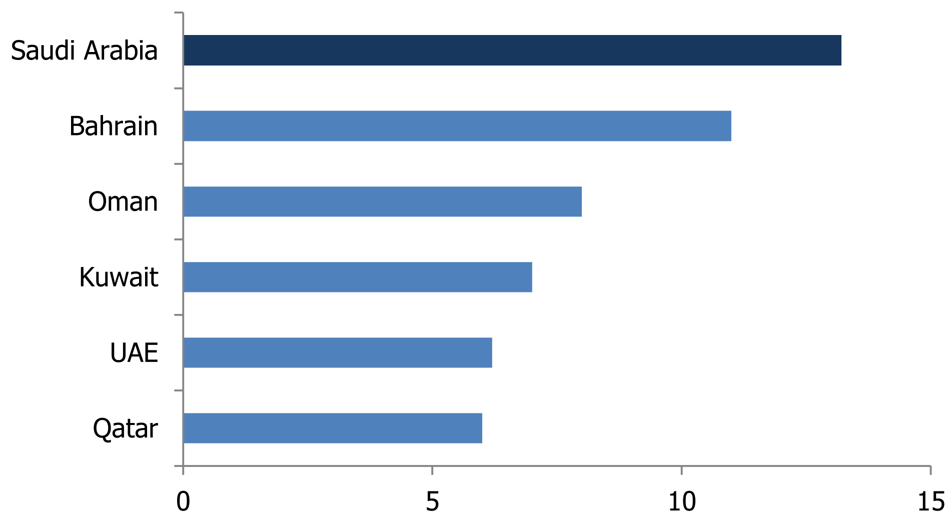
The low energy prices translate into significant budget costs for KSA. The estimated cost of energy subsidies for KSA was USD 107bn or 13.2% of the gross domestic product in 2015[2]. The low energy cost has also resulted in substantial increase in per capita energy consumption in KSA. GCC countries consumed 9.2 tonnes of oil equivalent (TOEs) per capita in 2014, as against the world average of 4 TOEs per

[2] IMF estimates – Financial Times

capita. The energy consumption isn't just at high levels but it has increased significantly over a period of time. Energy consumption per capita in Saudi Arabia has grown at an annual average rate of 2.5% during the last 40 years – the average growth rate for countries with similar income per capita has been only 1%. Though energy consumption is influenced by several factors such as income, climate and geography, availability of relatively cheap energy is one of the key factors influencing the high energy consumption in KSA.

Energy consumption per capita in Saudi Arabia has grown at an annual average rate of 2.5% during the last 40 years.

GCC Fuel Subsidies as of % of GDP (2015)



Source: IMF; Note: Approximate figures

Energy Price Reform and what follows next?

On December 29, 2015, KSA increased the price of higher-grade unleaded petrol to USD 0.24 per liter from USD 0.16, a hike of 50%.

On July 1, 2010 KSA increased the average price of electricity sold to non-individual users by c. 20%. KSA recently has set-up an independent body - Saudi Energy Efficiency Center (SEEC), to overlook energy efficiency awareness programs for energy users and has established tougher building codes and appliance standards. The SEEC was created in October 2010 and is responsible for the development of energy efficient technologies and conservation policies. The SEEC targets households, whose energy consumption has soared in recent years, through awareness campaigns, strengthened minimum energy efficiency ratios for air conditioners (AC), and labels for electrical appliances. In addition to these efforts the recent decline in oil price and subsequent budget gaps has forced KSA to consider rising its domestic energy prices.

On December 29, 2015, KSA increased the price of higher-grade unleaded petrol to USD 0.24 (SAR 0.90) per liter from USD 0.16 (SAR 0.60), a hike of 50%. Lower-grade petrol has been hiked to USD 0.20 (SAR 0.75) from USD 0.12 (SAR 0.45) per liter. In addition to these reforms KSA is also considering plans to raise charges on public services and to apply value-added tax.

A 10% increase in the price of electricity, gas and other fuels would increase inflation by 0.2 percentage points in KSA.

Inflation

The share of energy products in the consumption basket/index will determine the impact of higher energy prices on inflation. However, the direct impact is expected to be low as the weightage of energy products in the consumer price index (CPI) is relatively small for KSA. Indirect impact would also be limited, as evident from the table below, where products/services that are relatively intensive in the use of energy, particularly transportation services, also have a relatively low weight in the CPI. A 10% increase in the price of electricity, gas and other fuels would increase inflation by 0.2 percentage points in KSA. The low impact of price rise in energy products on inflation is evident from the case of UAE. The 25% increase in gasoline prices in the UAE in the August 2015 accompanied with a 29% reduction in the price of diesel, resulted in negligible influence on inflation which was measured at 4.9% in August as against 4.4% in July[3].

Weights of Energy Products in the CPI, in percent[1]

CPI Item	Bahrain	Kuwait	Saudi Arabia[2]
Housing			
Electricity, gas and other fuels	**2.02**	**0.53**	**1.83**
Electricity	1.73	0.35	1.59
Gas	0.27	0.12	0.18
Other Fuels	0.02	0.05	0.07
Transport			
Fuels and Lubricant	**3.42**	**2.11**	**1.46**
Gasoline/Diesel	3.26	1.79	-
Lubricants	0.16	0.31	-
Energy Products, Overall	**5.44**	**2.63**	**3.29**

Source: IMF, 1 – CPI Base years (Bahrain – 2006, Kuwait – 2007), 2 - weights calculated based on average monthly household expenditure by expenditure group.

The initial increase in the domestic energy prices would result in negative shocks to the productive sector.

Economic Growth – Short term & long-term

The initial increase in the domestic energy prices would result in negative shocks to the productive sector. The production costs in energy intensive sectors such as aluminum, chemicals, metals, mining, plastics, petroleum refining, and steel is expected to increase due to higher energy prices. Additionally, firms in export related sectors whose product prices are determined in the global markets are also expected to be affected, due to the challenge of passing on the increased costs to consumers. The affected firms would have to enhance the efficiency of their production process to offset the higher energy costs. Economic activity in the country would be impacted due to reduced spending as a result of higher costs and lower profits. However, in the long-term the energy price reform would have a positive impact on economic growth. The increase in energy price would result in rational and efficient energy consumption. In the long term, the less competitive firms will be pushed to adjust and relocate capital and employ labor in a more efficient way.

[3] IMF

The estimated income gain from the energy price increase to match an international benchmark such as US pre-tax prices is c. 1.5% to 2.1% of the GDP for KSA. The gain for KSA is large compared to other GCC countries such as UAE (0.1–0.2), Oman (0.4-0.7), Qatar (0.5-0.8) and Bahrain (0.6-0.9). If the income from the reform is reinvested this can generate additional income estimated at USD 0.7bn to USD 1bn for the KSA government[4].

The estimated income gain from the energy price increase to match an international benchmark is c. 1.5% to 2.1% of the GDP for KSA.

Though the low energy prices has helped achieve rapid economic development and raise living standards in KSA, it has indirect costs in terms of the exorbitant growth in domestic energy consumption and opportunity costs of resource usage. The lower oil price environment is forcing KSA to consider embarking on energy price reform. Though economic and social implications pose a challenge to the government, these potential downside risks can be managed through proper design of reform programs. Moreover, in the long-term, energy price reforms would generate income gains, rational consumption and improved efficiency contributing to the economic growth.

[4] IMF

Investment Implications

Impact Indicator

Investment Arena	Relative Impact
Stock Market	Negative
Bond Market	Neutral
Real Estate	Negative
SME	Negative

Source: Marmore Analysis

The rise in fuel prices is expected to result in increased constructions costs.

Stock Market: As discussed earlier the surge in fuel prices will have limited impact on inflation, due to its insignificant share in the consumption basket. However, the production costs in energy intensive sectors such as aluminum, chemicals, metals, mining, plastics, petroleum refining, and steel is expected to increase due to higher energy prices. Higher operating costs coupled with lower realisation for their products which are predominantly commodity based could lower their earnings. Thus, we rate this factor as a negative for stock markets.

Bond Market: During 2015, the KSA bond market was dominated by sovereign issues. The sovereign issuances were to plug the deficit due to lower oil revenues. However, measures such as fuel subsidy reforms will result in lower expenditure and cover the deficit to some extent. The decline in expenditure will marginally lower the need for the KSA government to raise funds from the debt markets. Since the overall impact of energy price reform in marginal, this is expected to have neutral impact on the bond markets.

The fuel price surge is expected to a have negative impact on SMEs, as the production costs manufacturing segment companies would increase.

Real Estate: The rise in fuel prices is expected to result in increased constructions costs. However, since the rise has no significant inflationary impact as discussed earlier, it is unlikely to impact the Real Estate sector performance significanly. Hence we expect the energy prices reform to have neutral impact on Real Estate sector.

SME: The fuel price surge is expected to a have negative impact on SMEs, as the production costs from companies especially operating in the manufacturing segment would increase. The SME's inability to pass the operational costs to the end users due to the competitive markets they operate in impacts profitability. Therefore, the energy price reforms are expected to have negative impact on the SMEs in KSA.

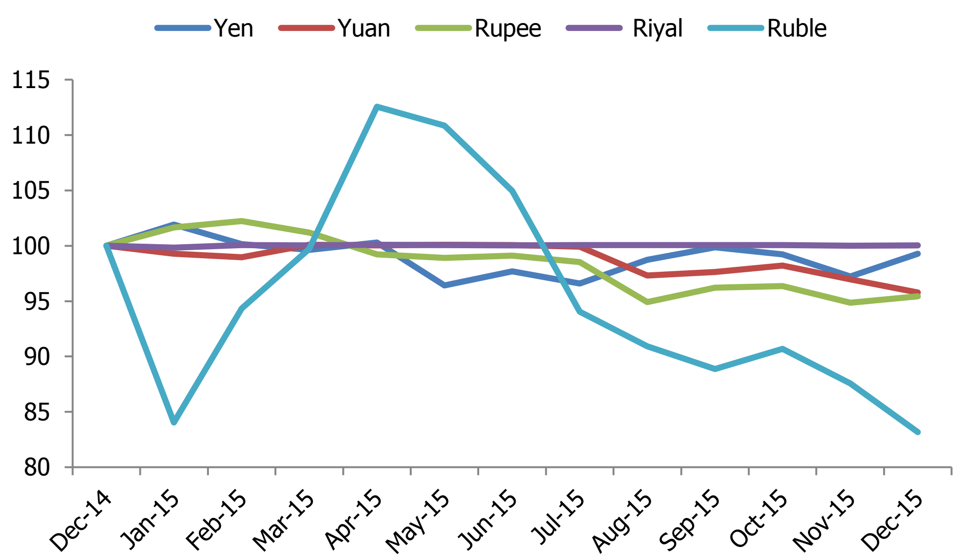
Theme 2: KSA Currency: Where is it heading?

Exchange rates play a significant role in determining a country's economic health. The emerging markets have historically witnessed a push in their economic output after the devaluation of their currencies. According to IMF estimates a 10% fall in the value of a nation's currency can boost exports by an average 1.5% of GDP. This clearly emphasizes the benefits of a cut in the exchange rate for foreign trade and incentivizes the government's enough to embark on currency devaluation.

According to IMF estimates a 10% fall in the value of a nation's currency can boost exports by an average 1.5% of GDP.

Currencies of several economies have lost value against USD since the beginning of 2015. As evident from the table below, Japanese Yen, Chinese Yuan, Indian Rupee and Russian Ruble have all declined by 0.7%, 4.2%, 4.6% and 16.8% respectively. The decline of several currencies has sparked the fear of a potential currency wars, especially amongst the emerging economies. However, Saudi Arabia has continued to maintain its peg to USD and due to which it is spending more FX reserves during a low oil revenues regime resulting in lower inflow of FX.

Exchange Rate against USD



Source: Reuters, Marmore Research; Values rebased to 100 at start of 2015

Most of the world's biggest oil and commodity exporter's currencies have lost value during 2015.

Major Oil Producer's Currencies

Most of the world's biggest oil and commodity exporter's currencies have lost value during 2015. Russia's ruble declined 30%, Norway by 12.6% and Canada by 15.5%. As the commodities are priced in USD, these countries have been able to weather the impact of lower oil revenue to some extent due to depreciation of their currencies against dollar. The currency depreciation benefits the country's oil producers, since they pay for oil production in local currency, but receive revenues in dollars. However, oil producers that have their currency pegged to USD are deprived of this advantage. If KSA continues to hold its peg, its revenue from oil would continue to decline, unless the oil prices increase. The longer oil languishes, the more pressure builds on Saudi Arabia to abandon its currency peg.

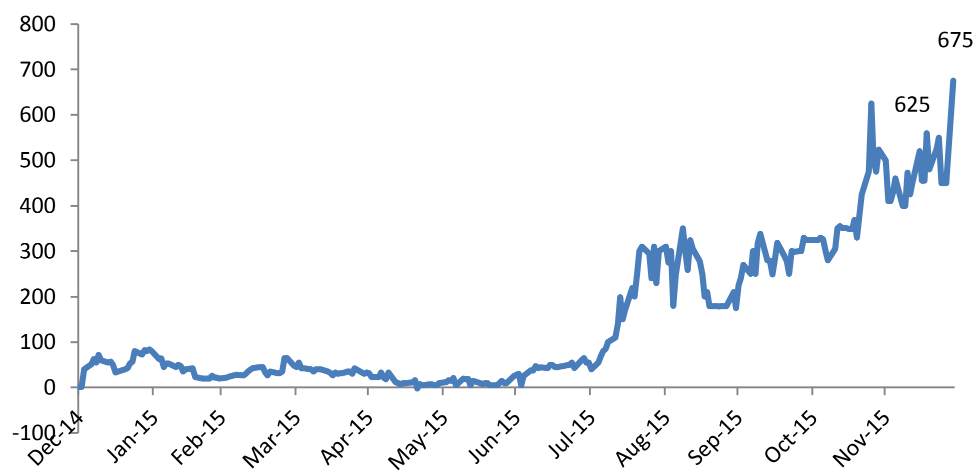
Currency Change against USD (November, 2014 – November, 2015)

Saudi Riyal: **+0.03%**	**Chinese Yuan:** **-4.1%**	**Canadian Dollar:** **-16%**	**Mexican Peso:** **-17.7%**
Norwegian Krone: **-21.6**	**Russian Ruble:** **-30.3%**	**Colombian Peso:** **-30.6%**	**Brazilian Real:** **- 32.1%**

Source: FT, Marmore Research

Events such as the devaluation of the Yuan and Kazakhstan relinquishing the currency peg led to the speculation that Saudi might abandon the currency's peg to the dollar. The one year forward swap for US Dollar/Riyal is trading at 675 points. Forward rates are used as an indicator of risk in the region, and to hedge against market fluctuations. This has prompted a speculation that KSA may abandon the riyal peg to the USD.

USD/SAR 1 Year Forward Swap



Source: Reuters, Marmore Research

The foreign exchange reserves have fallen by about USD 80bn during 2015 which stood at USD 732bn at the end of 2014. The rate of the reserves' decline is likely to slow as the fiscal deficit would shrink to 16% of the gross domestic product in 2016 from 19.7% of GDP in 2015.

Additionally, the current account balance is set to return to a surplus from 2.4% deficit in 2015, and the economy continues to grow at a stable pace. All these factors clearly imply the unlikelihood of Saudi Arabia abandoning its currency peg to the USD.

Investment Implications

Impact Indicator

Investment Arena	Relative Impact
Stock Market	**Positive**
Bond Market	**Positive**
Real Estate	**Neutral**
SME	**Neutral**

Source: Marmore Analysis

KSA, in June 2015, permitted the participation of Qualified Foreign Institutional Investors.

Stock Market: KSA, in June 2015, permitted the participation of Qualified Foreign Institutional Investors. This is expected to bring in increased foreign investment in the future. A stable .i.e. pegged currency gives greater comfort and confidence to foreign investors to invest in the market due to absence of currency risk. Therefore, KSA's continued SAR peg to USD will have a positive impact on the stock market.

Bond Market: During 2015, the KSA bond market was dominated by sovereign issues and the government is also considering to tap international bond market in 2016. Since the currency peg eliminates the exchange risk and the associated hedging costs, it will have a positive impact when it comes to raising debt from international bond markets.

The SMEs importing goods and services would benefit from USD being strong during 2015 as the imports would be cheaper.

Real Estate: Factors such as high tourism levels, increasing population and high disposable income have been some of the key drivers for the real estate sector in KSA. These factors are unlikely to be impacted due to the currency peg and additionally, foreign investment in KSA real estate is not permitted. Therefore, currency peg is expected to have no impact on the domestic real estate market.

SME: The SMEs importing goods and services would benefit from USD being strong during 2015 as the imports would be cheaper. On the contrary the exporters in KSA lose the competitive edge in the global markets as the exports become expensive due to stronger USD. However, the overall impact is expected to be neutral for SMEs due to the SAR-USD peg.

Theme 3: Labor Reform in KSA

KSA's dependence on low-wage foreign labor was one of the key factors of the oil driven growth model that produced swift economic development. Though dependence on foreign labor helped KSA overcome the shortage of local labor, it has now created distortions in the KSA labor market and resulted in increased dependence on nationals for public sector employment. These distortions post the constraint of inability to employ fast growing educated national workforce in the private sector. As the private sector continues to employ expatriates it has resulted in high unemployment rates for nationals, particularly among youth. Realizing these challenges, authorities in the KSA have adopted a reform strategy with the objective of increasing employment of Saudis in the private sector.

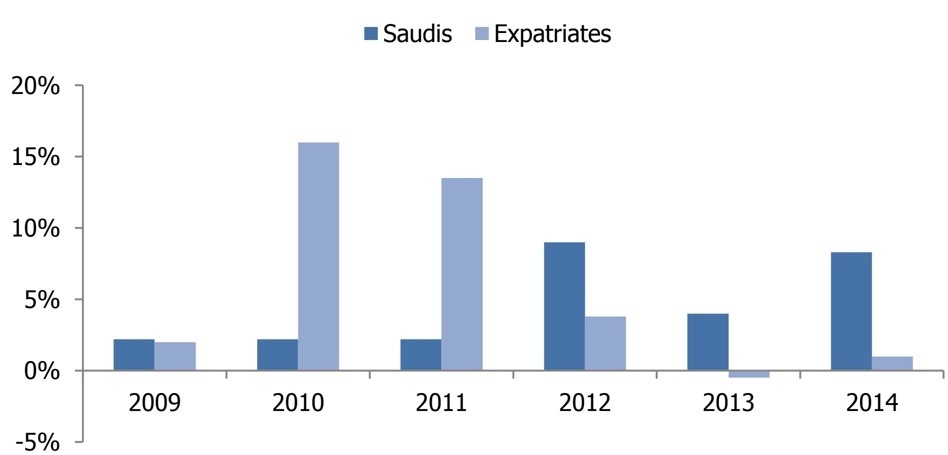
KSA's dependence on low-wage foreign labor was one of the key factors of the oil driven growth model that produced swift economic development.

Labor Reforms and Initial Impact

Investment in Education Sector: The public spending on education increased significantly from c. 5.3% of GDP in 2008 to c.8% in 2014. The increased spending led to school attainments and improvement in technical education through partnerships with well-reputed international universities. However, the current education system is not fully equipped to cater to private sector needs in terms of technical and vocational skills.

Nitaqat Program: The Ministry of Labor launched in 2011 a number of labor initiatives with a view to increase employment opportunities for its citizens in the private sector. The implementation of Nitaqat program has resulted in increased employment of nationals in the private sector as evident from the figure below. Also nationals account for an increasing share of new jobs created.

Saudi and Expatriate Employment % Growth in the Private Sector



The public spending on education increased significantly from c. 5.3% of GDP in 2008 to c.8% in 2014.

Source: IMF, Note: Approximate Figures

Minimum Wage for Nationals: The authorities introduced a minimum wage of SAR 3,000 per month that has to be paid to earn the full Nitaqat credit[5], which has resulted in an increased wage gap between the nationals and expatriates.

The authorities introduced a minimum wage of SAR 3,000 per month that has to be paid to earn the full Nitaqat credit.

Implications of Reforms

Macroeconomic: The macroeconomic outcome over the last decade to a certain extent was shaped by the availability of low-wage workers. The low-wage expatriate population eliminated the cost challenges of the private sector during the early stages of development while containing wage rise pressures during upswings in the oil cycle. The low-wage environment in the private sector led to a pattern of low productivity and disincentives for nationals to build the skills needed in the private sector. Additionally, the public sector employment further reduced incentives for nationals to seek private sector jobs. However, the recent labor and education reforms aim to change the dynamics and result in higher share of nationals working in the private sector.

Fiscal: KSA is more likely to face the pressure to create jobs for nationals in the future years due to young and growing population and also higher participation of nationals in the private and public sector. Approximately 1.6 to 1.8million nationals is forecasted to enter the labor market between 2014 and 2020[6]. However, IMF estimates that with the existing reforms it is highly unlikely that private sector will create enough jobs to absorb new entrants in the labor market. This would result either in increased unemployment rates among nationals or the government will be forced to hire new labor market entrants into the public sector causing the wage bill to balloon. If the government aims to keep the unemployment rate constant at its 2014 level (11.7%), employment growth in the public sector would need to be 5.2% annually during 2015–20 and this would increase the wage bill to about 15 percent of GDP by 2020.

Approximately 1.6 to 1.8million nationals is forecasted to enter the labor market between 2014 and 2020.

However, effective new labor reforms leading to an increase in employment of nationals in the private sector could result in lower unemployment and subsequently lower fiscal burden.

[5] Employers can count a Saudi as a "full employee" only if the wage is SR 3,000. For employees earning less, they are considered only "half" a Saudi employee.
[6] IMF

Despite the higher growth during the oil boom period, significant expatriate population helped reduce the inflationary impact.

Employment and Wage Bill Projections 2015–20 (in Thousands of Persons)

	2014	2020 baseline		
		Scenario 1[7]	Scenario 2[8]	Scenario 3[9]
Saudi labor force	5,577	7,180	7,389	7,389
Employed in public	3,270	4,066	4,066	4,420
Employed in Private	1,656	2,040	2,111	2,111
Unemployed	651	1,073	1,212	858
Unemployment Rate (%)	11.7	14.9	16.4	11.7
Wage Bill/GDP (%)	11.9	13.6	13.6	14.7

Source: IMF

Inflation: Despite the higher growth during the oil boom period, significant expatriate population helped reduce the inflationary impact. The elastic supply of expatriates has limited pressure on wages and also the significant remittance outflows aided in keeping the inflation in check. However, as the KSA private sector employs more and more nationals, this will lead to inflationary pressure in KSA. The first impact will be through wages which will increase in response to the labor reforms such as the minimum wage policy. Therefore, it is imperative that the labor reforms are implemented gradually to help ease inflationary pressures.

KSA government has embarked on several labor reforms to increase the employment of the nationals in the private sector. However, measures are also required to improve the attractiveness of wages in private sector at par with public sector. In order to limit any potential fiscal, inflationary, wages and macroeconomic disruptions, it would be ideal to gradually substitute expatriate with the national workforce.

7 Assumes fixed share of nationals in the private sector as in 2014 at around 21%, and labor participation rate continues its recent improvement but at a slower pace, so number of new entrants is 1.6 million over next 6 years. Public employment growth stays at 3.7%. Wage rates are assumed to grow by 2% annually in all the scenarios

8 Assumes continued improvement in the share of nationals in the private sector to reach 23% by 2020 and recent trend in the growth of number of entrants to continue at same pace. Public employment growth stays at 3.7% annually

9 Assumes government aims to keep unemployment at 2014 level, by increasing public employment growth to 5.2% annually.

Investment Implications

Impact Indicator

Investment Arena	Relative Impact
Stock Market	**Negative**
Bond Market	**Neutral**
Real Estate	**Negative**
SME	**Negative**

Source: Marmore Analysis

The labor reforms to increase the nationals workforce count in the private sector is expected to impact the performance of companies.

Stock Market: The labor reforms to increase the nationals workforce count in the private sector is expected to impact the performance of companies. The first channel of impact on prices will be through wage increase due to minimum wage reforms. The impact on total costs could be large in labor intensive sectors such as hospitality, real estate and retail. The increased costs will translate into lower corporate earnings for companies and thus negatively impacting the stock market.

Bond Market: The labor reforms will have neutral impact on bond markets. The companies foreseeing higher expenses could raise additional capital on bond markets. However, it is expected to be negligible and thus we have a neutral view on the impact.

The labor reforms are expected to have negative impact on the SMEs due to the shortage of skilled nationals labor pool.

Real Estate: The real estate sector, especially the construction segment, is heavily reliant on the low wage expatriate population. The labor reforms in the form of Saudization, minimum wage requirement and limited working hours for private sector employees wherein, they are banned from working for more than 12 hours a day and a compulsory 30 minute break every five hours has posed a significant challenge to the industry and affected the profitability of the companies operating in the segment. Moreover, the decreased expatriate population as a result of Saudization is likely to translate into lower demand for residential rental properties further adding pressure to the real estate sector.

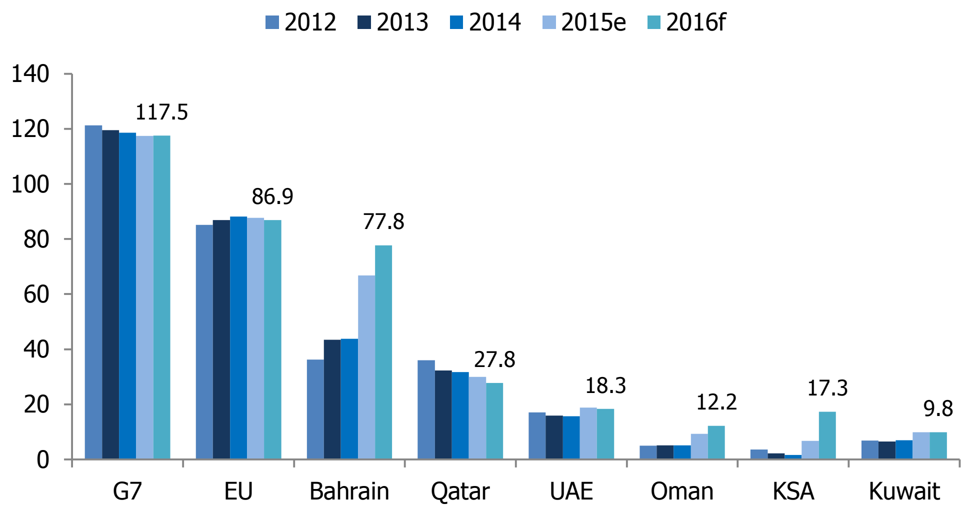
SME: The labor reforms are expected to have negative impact on the SMEs due to the shortage of skilled nationals labor pool. Moreover, the minimum wage for nationals imposed by reforms will significantly increase the operating costs of the SMEs resulting in declined profits.

Theme 4: Local Debt Market Development – KSA

For the first time since 2007, the Kingdom of Saudi Arabia raised funds through bond issuance and in the year 2015.

With the lower oil prices inflicting dents in public finances, KSA has turned to bond markets. For the first time since 2007, the Kingdom of Saudi Arabia raised funds through bond issuance and in the year 2015, KSA turned out to be the most active issuer. Considering that KSA will post the largest fiscal deficit amongst the GCC countries in 2015, it is expected to continue raising funds from bonds markets to plug the fiscal shortfall. Due to which, the KSA government debt which was less than c.2% of the GDP at the end of 2014, is expected to reach 17.3% in 2016.

Government Gross Debt (as % of GDP)



Source: IMF; G7 Countries consists of Canada, France, Germany, Britain, Italy, Japan & U.S

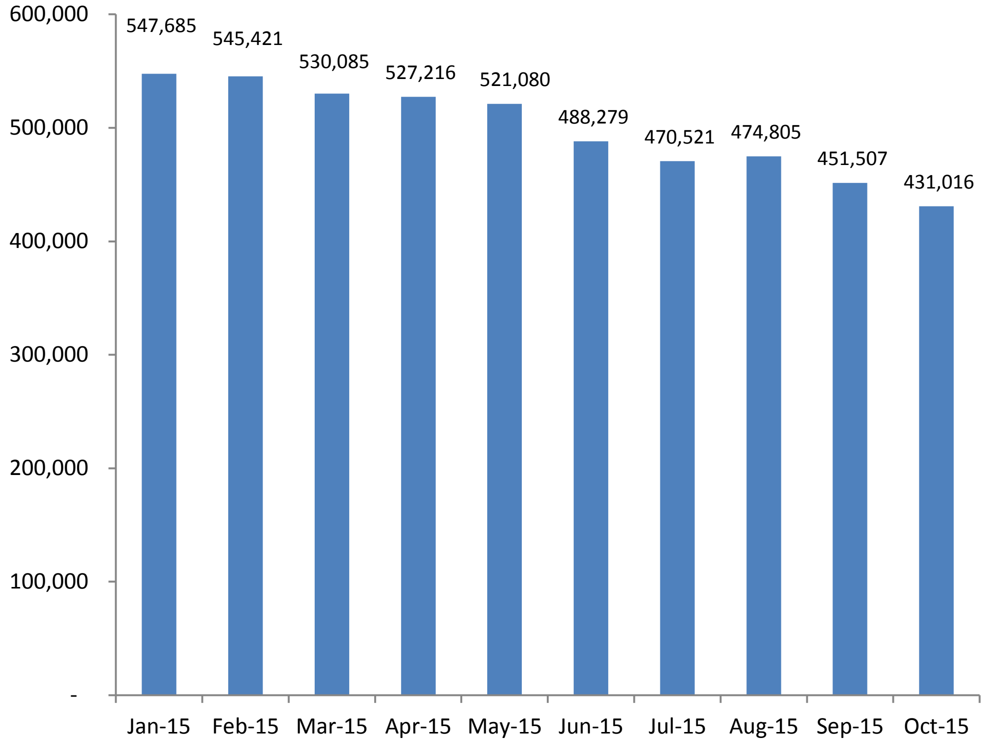
Saudi Arabia sovereign debt commands an investment grade rating of Standard & Poor's - 'A-plus/A-1', Moody's - Aa3 one notch above S&P, with a stable outlook, and Fitch - AA two notches above S&P, with a negative outlook for the year 2016. In 2015, KSA government posted a deficit of USD 95bn and IMF estimates that KSA could exhaust its financial reserves in less than 5 years unless the government curbs its expenditure and raises other streams of revenue.

During 2015, KSA withdrew approximately USD 70bn from global asset managers to plug deficit.

During 2015, KSA withdrew approximately USD 70bn from global asset managers to plug deficit and additionally turned to domestic bond markets to cover the deficit[10]. SAMA's statisitcs on Investments in Foreign Securities shows a decline of USD 117 bn in the period of Jan 2015 to Oct 2015 (refer below chart). KSA is expected to continue its sovereign issuance through 2016 and likely 2017 as well. Moreover, if liquidity in the domestic banking system tightens significantly, the government may also have to consider selling sovereign bond or sukuk into the international market or more widely domestically to non-bank domestic investors.

[10] Bloomberg

KSA Investment in Foreign Securities (USD Mn)



Source: SAMA

Standard &Poor's estimates that KSA domestic banks could support bond purchases of only upto USD 100bn.

A total of USD 30bn was raised by the Ministry of Finance in six different tranches issued between July and December 2015. Standard &Poor's estimates that KSA domestic banks could support bond purchases of only upto USD 100bn. Excessive reliance on the bank funding could squeeze liquidity in the financial system. Slow mobilization of government deposits, as a consequence of lower oil revenues and withdrawal of government deposits will impact the banking sector. KSA increased its reserve repurchase rate to 0.50%, up from 0.25%, in line with the U.S Federal Reserve's interest rate rise. However, this is unlikely to raise the cost of sovereign debt issuance for Saudi Arabia as the Fed rate hike was already priced in the earlier bond issuances.

Conventional Bond Issuances in Saudi Arabia (2011-2015) (USD Mn)

Issuers	2011	2012	2013	2014	2015
Ministry of Finance - Saudi Arabia	-	-	-	-	30,660.13
Saudi Basic Industries Corporation	266.61	-	1,821.55	-	-

Source: Zawya; Note: Most debt by corporates were raised as Sukuks

Additionally, deleveraging acts, introduction of Basel-III norms entailing additional capital needs may stress banks and their lending might be constricted, as business cycle changes.

Development of local debt markets could provide an additional source of avenue for capital rising.

Raising debt in the domestic market, if done in a measured way, could help in the establishment of an active and liquid debt market. Development of local debt markets could provide an additional source of avenue for capital rising on a long-term basis. Creation of local debt market would also help in establishing the much needed yield curve, which could help in better pricing of risk for future issues. Regular issuances of sovereign bonds could help deepen the Saudi debt market which, if it creates a yield curve across multiple tenors, could potentially flag off strong corporate issuances. The creation of a robust corporate debt market will shift the corporate risks into the capital markets and away from the banking system. This will create a more stable and well balanced financial system. Issuance of corporate bonds would also be advantageous from investor's perspective, as it would provide a steady stream of predictable income in the form of coupon payments, while retaining capital value.

The low interest rate environment in the international markets make it ideal for raising debt in these markets.

The low interest rate environment in the international markets make it ideal for raising debt in these markets. As oil revenues are denominated in dollars, servicing them may not entail currency risk. Moreover, managing fiscal deficit by placing bonds with the domestic banks alone, would not be a prudent long-term strategy as this would lead lead to liquidity squeeze in the domestic market.

KSA has sufficient financial reserves to manage its deficit, however, the high opportunity costs associated with draw down of reserves make it unattractive. The availablilty of debt at the cheaper rate relative to the opportunity costs for Sovereign Wealth Funds (SWFs) make debt a more viable option. Moreover, incorporating debt would instil tighter fiscal consolidation, to enable regular debt service payments.

Factors That Argue for Raising Debt

Higher Sovereign Ratings	• GCC Sovereigns command higher credit rating • Rating on par with most Developed economies.
Low Debt Levels	• Current government debt levels are low (GCC, Total debt: 9% of GDP) compared with G7 economies (117% of GDP)
Record Low Interest Rates	• External economic environment is supportive • Record low interest rates could be utilized to borrow.
Help Establish Debt Market	• Debt market could alleviate pressure on local bank financing methods • Subsequently, benchmark 'yield curve' could be established
Opportunity Cost of SWF is much Higher	• SWF being long-term in nature should ideally earn higher returns , esp. against cost of government debt.
Ensures Disciplined Spending	• Adding on debt would also ensure disciplined spending , going forward, as it entails regular interest payments.

Source: Marmore

Investment Implications

Developing a bond market serves as an alternative funding source for companies which are presently dependant on the banks.

Impact Indicator

Investment Arena	Relative Impact
Stock Market	**Positive**
Bond Market	**NA**
Real Estate	**Positive**
SME	**Positive**

Source: Marmore Analysis

Stock Market: Developing a bond market serves as an alternative funding source for companies which are presently predominantly dependant on the banks for funding. The developed debt markets allow the companies to raise financing at a cheaper rate relatively to the bank funding. This positively impacts the financial performance of the companies in the form of increased profits.

Bond Market: NA

Creation of local debt markets would be a positive development for the real estate sector.

Real Estate: Creation of local debt markets would be a positive development for the real estate sector. Private real estate players looking to diversify their funding sources can use the debt market to raise additonal capital to fund projects. Considering the anticipated tightened liquidity in the KSA banking system due to lower oil price, developed debt markets can be benefical to the companies operating in the real estate sector.

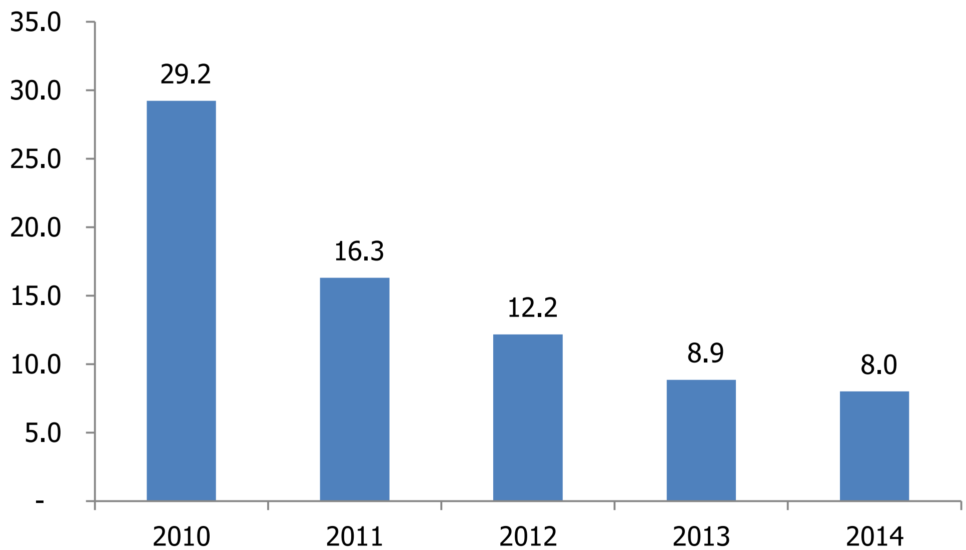
SME: Though KSA has an active SME Loan Guarantee Program such as KAFALAH, obtaining financing continues to be a challenge for the SMEs. The creation of a debt market would aid SMEs to gain access to much needed liquidity. However, the advantage might be limited as they might find the process of raising debt challenging.

Theme 5 – Foreign Investment Reforms

KSA has been one of the largest markets in terms of attracting foreign direct investment in the GCC region. According to United Nations Conference on Trade and Development (UNCTAD), KSA was ranked as the third largest FDI recipient in Western Asia, after Turkey and the United Arab Emirates during 2014. However, it has experienced a steady decline in foreign direct investment since 2011 and the trend is expected to continue in the near future. In-order to turn around this downward trend and to diversify the hydrocarbon-dependent economy to reduce the shocks of oil slumps and create jobs for nationals, the Government has embarked on several reforms. Opening of Tadawul to foreign investors and permitting 100% FDI in retail sector are some of the reforms introduced to attract foreign investments in KSA.

KSA was ranked as the third largest FDI recipient in Western Asia, after Turkey and the United Arab Emirates during 2014.

FDI in KSA (in USD bn)



Source: World Bank

100% FDI in Retail

Previously 100% foreign investment even in the permitted sectors was not allowed.

KSA's FDI law permits foreigners to invest in all sectors except a few specific activities mentioned in the "negative list" that currently includes two industrial sectors and 13 service sectors. All foreign investment projects require approval from SAGIA and previously 100% foreign investment even in the permitted sectors was not allowed. However, the recent reform allowing 100% ownership of retail and wholesale businesses by foreign investors can be deemed a positive move to attract foreign investors. This move is expected to attract foreign companies and incentivize them to manufacture their products in KSA to sell them directly to the consumer. This also eliminates the need for a Saudi partner who usually would acquire at-least 25% stake in the business with very limited value addition. This 100% FDI allowance is applicable to only single brand retailers such as Apple and Samsung and not multiple brand retailers such as Walmart and Tesco. SAGIA though has emphasized that foreign companies must ensure the creation of job opportunities and provide training for Saudi citizens under the kingdom's ongoing Saudization project. The approach aims to increase competitiveness and provide better work opportunities to Saudi youths, by enabling them to be trained in centers affiliated to these companies. KSA's decision to open its retail market to foreign investors is set to attract USD 2.66bn of foreign investments in the next one year[11].

Tadawul Open to Foreign Investors

KSA's decision to open its retail market to foreign investors is set to attract USD 2.66bn of foreign investments in the next one year.

In June 2015, Saudi Arabia's stock market was opened to foreign investors which would attract overseas investment in coming years. This is forecasted to attract investments ranging from USD 20bn to USD 50bn in the KSA equity markets. This is also expected to expedite KSA's inclusion in the MSCI emerging market index to as early as 2017. The move was part of the government's broader reform efforts that seek to boost the private sector and reduce oil revenue dependency. A major worry about KSA stock market is the lack of institutional investors and predominant presence of retail investors. However, with this move, to permit Qualified Foreign Institutional Investors (QFIIs), the regulator has tried to address both the issues: - absence of institutional and foreign investors from the market. Institutional investors provide the much needed stability and liquidity to the markets and can significantly deepen the market.

[11] AMEinfo

Investment Implications

The foreign investment is expected to result in increased efficiency through the transfer of new technologies and increased competitiveness.

Impact Indicator

Investment Arena	Relative Impact
Stock Market	**Positive**
Bond Market	Neutral
Real Estate	Positive
SME	Neutral

Source: Marmore Analysis

Stock Market: The foreign investment is expected to result in increased efficiency through the transfer of new technologies and increased competitiveness in the market. The improved efficiency is expected to translate into lower costs and better corporate earnings. Moreover, QFIIs Investment in the listed companies is expected to push for improved corporate governance and transparency of the listed companies. Also, QFIIs bring in long term investments which is vital for a market dominated by retail participants.

The 100% FDI in retail sector is expected to have positive impact on the real estate sector.

Bond Market: The reforms permitting FDI in the retail sector and QFIIs participation in Tadawul is expected to have neutral impact on the KSA bond market.

Real Estate: The 100% FDI in retail sector is expected to have positive impact on the real estate sector. As more foreign players start establishing operations in the KSA market, this is expected to result in increase in demand for retail real estate.

SME: Foreign investment would have a neutral impact on the SME sector since it has both positive and negative sides to it. The positive impact would come from capital and technology coming into the SME sector and the negative side would be the competition from foreign players eating up market share of the SMEs.

Appendix

A Selection of Key Reforms - KSA (2013-2015)

Country	Sector	Highlights
Kingdom of Saudi Arabia	Health Care	The Ministry of Health approved a national ten-year executive plan to control diabetes, 2010-2020.
	Financial Services	The Saudi Arabian Monetary Agency (SAMA) introduced a set of rules that requires insurers to apply actuarial pricing to their motor and medical policies.
		Outsourcing regulations issued for insurance companies, reinsurance companies and insurance service providers.
	Governance	Aramco to be restructured
	Education	Additional budget of SAR80bn was approved by the King in order to bolster the educational set up in the country.
	Capital Markets	The KSA opened Tadawul in June 2015.
	Private Enterprise	A new set of unified and regulated working hours for all workers in the Kingdom's private sector so that nationals feel encouraged to join the private sector.
	Foreign Investment	The KSA is set to ease restrictions on foreign investors to allow ownership of 100% of retail and wholesale businesses. The present level is up to 75%.
	Energy/Utilities	KSA has declared that it would adjust subsidies for water, electricity and petroleum products over the next five years (from 2016).

Source: Marmore Research

Key Economic Indicators	2012	2013	2014	2015e	2016f
Real GDP (SAR Billion)	2,289.3	2,350.4	2,431.9	2,510.6	2,540.9
Real GDP Growth (%)	5.4	2.7	3.5	3.2	1.2
Hydrocarbon, Real GDP Growth (%)	5.1	-1.6	1.5	3.3	2.3
Non-Hydrocarbon, Real GDP Growth (%)	5.6	6.2	5.0	3.2	0.4
Hydrocarbon exports (USD Billion)	337.7	321.9	284.4	162.6	165.1
Current Account Balance (% GDP)	164.8	135.2	76.8	-17.7	-20.0
Fiscal Deficit (% GDP)	-2.9	2.6	11.4	18.0	20.2
Hydrocarbon, GDP (% of Total)	45.4	43.5	42.7	42.7	43.2
Total Foreign Assets (USD Billion)	952.0	1,062.4	1,091.4	925.8	831.5
Inflation (%)	0.1	0.5	0.3	0.5	1.9
Central government revenue (SAR bn)	1,247.4	1,156.4	1,044.4	668.2	679.2
Hydrocarbon revenue (SAR bn)	1,144.8	1,035.0	913.3	530.6	538.5
Hydrocarbon revenue (% of Total)	91.78	89.51	87.45	79.41	79.29
Central government expenditure (SAR bn)	917.1	994.7	1,140.5	1,163.4	1,122.6
Current Expenditure (SAR bn)	611.6	594.0	670.0	730.3	690.1
Current Expenditure (% of Total)	66.69	59.71	58.74	62.78	61.47
Capital Expenditure (SAR bn)	305.5	400.7	470.5	433.1	432.5
Population (mn)	29.20	29.99	30.77	31.51	32.23
Per capita $ GDP	25,173	24,849	24,285	20,015	20,068
Crude oil production (barrels/day thousand; average)	9,790	9,637	9,712	10,052	10,303
Consumption of oil (b/d thousand; average)	2,935	3,067	3,205	3,349	3,500

Source: IIF

Disclaimer

This report has been prepared and issued by Marmore MENA Intelligence Ltd (Marmore), a fully owned research subsidiary of Kuwait Financial Centre "Markaz" K.P.S.C. Marmore is a private limited company registered with the Registrar of Companies in India.

The information and statistical data herein have been obtained from sources we believe to be reliable, but no representation or warranty, expressed or implied, is made that such information and data is accurate or complete, and therefore should not be relied upon as such. Opinions, interpretations, estimates, and projections in this report constitute the current judgment of the author as of the date of this Report. They do not necessarily reflect the opinion of Markaz or Marmore or other identified parties and are subject to change without prior notice. Neither Marmore nor Markaz have an obligation to update, modify, or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast, or estimate set forth herein, changes or subsequently becomes inaccurate, or if research on the subject company is withdrawn.

This Report may not consider the specific investment objectives, financial situation, and the particular needs of any specific person who may receive this report. Investors are urged to seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed or recommended in this report and to understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Investors should be able and willing to accept a total or partial loss of their investment. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily indicative of future performance.

Markaz may seek to do business, including investment banking deals, with companies covered in its research reports. Markaz may have interests in the areas covered in this research report. Markaz, Markaz managed entities, its clients, or its employees may have from time to time long or short positions in any security, derivative or other types of assets referred to in this research report. As a result, investors should be aware that Markaz may have a conflict of interest that could affect the objectivity of this report.

This report may provide the addresses of or contain hyperlinks to websites. Except to the extent to which the report refers to website material of Markaz and Marmore, Markaz has not reviewed the linked site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to Markaz's or Marmore's own website material) is provided solely for your convenience and information, and the content of the linked site does not in any way form part of this document. Accessing such website or following such link through this report or Markaz's or Marmore's website shall be at your own risk.

For further information, please contact 'Markaz' at P.O. Box 23444, Safat 13095, Kuwait; Email: info@e-marmore.com; Tel: 00965 22248280; Fax: 00965 22495741.

MARMORE
MENA INTELLIGENCE

Who we are

We are a research house specailized in MENA economies and business issues with the focus on providing actionable solutions.

What we do

Reports | Bulletin | Blogs
Webinars | Presentations | Videos

Our specialization

Industry | Regulatory | Infrastructure
Policy | Economic | Captial Market

Customized research

Feasibility | Business plan | Valuation
Database | White-label reports

Our country focus

Saudi Arabia
Kuwait
United Arab Emirates
Qatar
GCC MENA

www.emarmore.com
info@e-marmore.com