ميفك كابيتال
MEFIC Capital

SAUDI ARABIA 2018 OUTLOOK: MID-YEAR REVIEW

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Executive Summary

We at MEFIC Capital had released the Saudi Arabia 2018 Outlook report in January. This report is an effort to review our forecasts and attempt a course correction in places where required. We had reviewed the report from various asset class dimensions, which would include economy, equity markets and real estate.

The events, which have panned out so far in 2018, have been inline with our expectations. We have analyzed the same in Table: 1.

Table: 1 – Review of forecasts and outlook for rest of 2018

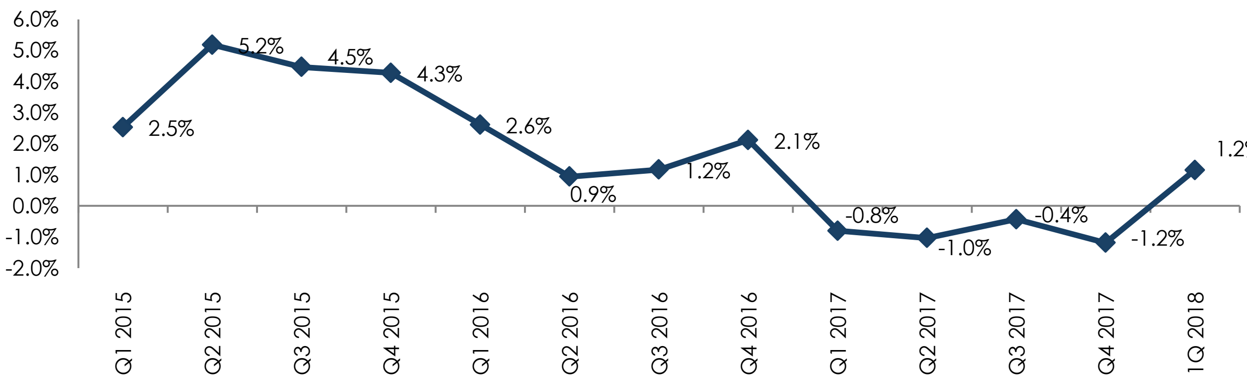
	Key factors	Expectations	Developments so far	Inline with expectations	Outlook
Economic Outlook	GDP growth	GDP growth to revive after de-growth in 2017	GDP growth for Q1 2018 +1.2% YoY	✔	Positive
	Fiscal Policy	Government spending to increase 20% YoY in 2018	Government spending in Q1 2018 up 17.8% YoY	✔	
	Oil Prices	Oil prices to rise	Brent crude price +11% YTD	✔	
	Debt issuance	Higher debt raising in 2018, compared to 2017	USD 11 bn of debt raised in April, government plans to borrow total of USD 31 bn in 2018	✔	
	Monetary policy	Increase in key interest rates	SAMA hiked interest rate twice in 2018	✔	
	Consumer spending	Consumption spending to increase based on government support	POS transactions have grown in high double digits YoY% during March to May 2018	✔	
Equities Outlook	MSCI /FTSE inclusion	Inclusion in FTSE and MSCI indices likely	Saudi Arabia included in FTSE and MSCI EM indices in March and June respectively	✔	Positive
	Earnings growth	Positive earnings growth trajectory	Q1 2018 earnings (ex-Utilities) up 4.4% YoY and 28% QoQ	✔	
	IPO Action	Saudi Aramco IPO in H2 2018, more vibrant IPO market	Saudi Aramco IPO looks unlikely in 2019, no new issuances except Leejam Sports (in process)	X	
Real Estate Outlook	Real Estate Prices Construction Activity Transactions Value REITs	Cautious outlook Listing of new REITs	Real Estate Price Index stagnant Real estate transactions value declines 32% YoY during the year 4 new REITs listed	✔	Cautious

Saudi economy on revival path

GDP growth revives in Q1 2018

As expected, Saudi Arabia's economy started to recover in Q1 2018, after contracting 0.7% during 2017, backed by accelerated growth in both the oil and non-oil sectors. GDP in constant prices grew 1.2% YoY to SAR 647.8 bn in Q1 2018, in contrast to 2017 when it fell in every quarter. We had expected that greater government spending and oil prices on the rise will help in reviving economic growth in 2018. Helped by higher budgetary spending in Q1 2018, along with a multi-billion dollar fiscal stimulus announced earlier in December 2017, the non-oil sector (accounting for 57.3% of GDP) grew 1.6% YoY. Oil sector also grew 0.6% YoY in the quarter, backed by higher oil prices and gradual increase in oil production after Saudi Arabia completed the required production cuts as per OPEC deal by the start of 2018. The International Monetary Fund (IMF) upgraded its 2018 growth outlook for Saudi Arabia twice, first in April to 1.7% from 1.6% earlier, and later in July to 1.9%. The World Bank also increased its growth expectation to 1.8% from 1.2% in April.

Figure 1: Saudi Arabia Quarterly GDP growth (%)



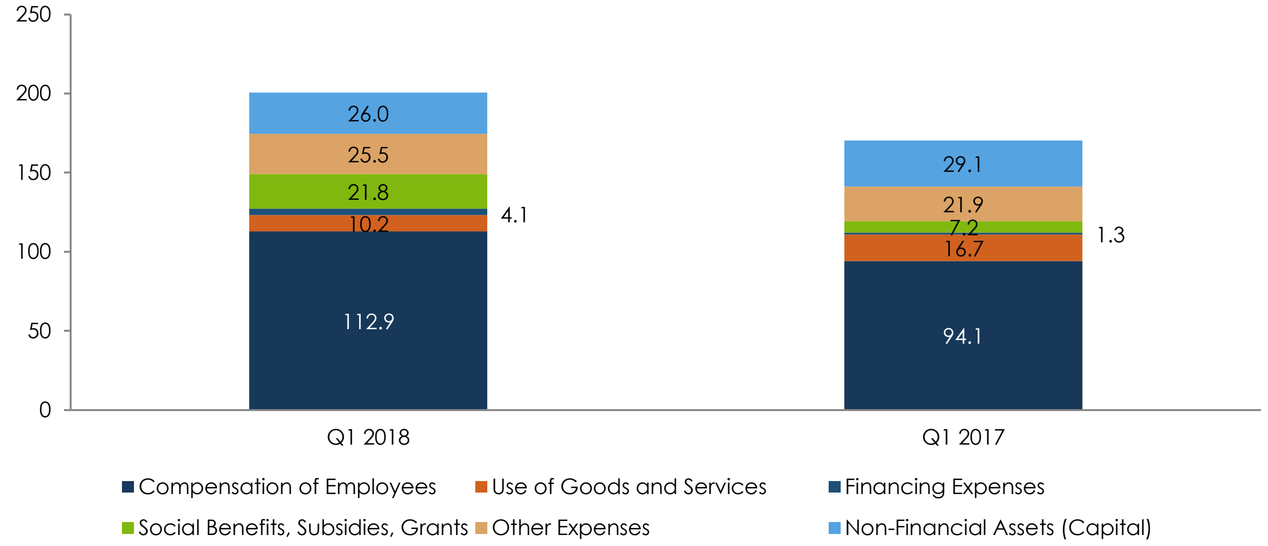
Source: General Authority for Statistics

Government spending increases 17.8% YoY in Q1 2018

In line with the announced budget for 2018, government expenditure in the first quarter of 2018 increased 17.8% YoY to SAR 200.6 bn. The total budgeted spending for 2018 is SAR 1,111 bn, or 20% more than the previous year. Increase in employee compensation (20% YoY), which holds the largest share of total expenditures (56%), was the main driver of higher government expenditure. Social benefits substantially increased (184% YoY), driven by series of new allowances announced by the government to offset higher cost of living due to introduction of VAT and higher electricity and fuel prices.

In terms of sector wise expenditure distribution, maximum allocation went to Military, Education and Health & Social Development sectors. Economic Resources and Infrastructure & Transport were the most underspent sectors, with only 4% and 7% allocation of the total annual budgeted amount spent in Q1 2018. Higher amount is expected to be spent on these sectors in the subsequent quarters, in line with the budgetary allocations.

Figure 2: Q1 2018 Expenditure vs. Q1 2017 Expenditure (SAR bn)



Source: Ministry of Finance

Oil prices on the rise, Saudi oil production increases during Q2 2018

Global crude oil prices started to stabilize towards the end of 2017 and during Q1 2018 with Brent crude spot price hovering just below USD 70 per barrel levels, as the market realized the commitment of oil producers participating in the production cut. The oil prices started to rise in April 2018 amidst anticipation of US sanctions on Iran. They continued to rise after the US officially confirmed in May that the sanctions would take place. Overall, the Brent crude rose 11% YTD during 2018 (as of July 26th), which reflected positively on the Saudi economy.

Saudi Arabia started to increase its oil production during Q2 2018 after completing the required production cuts as per OPEC deal, with the daily average output rising 1.7% on QoQ basis. Saudi's oil output is expected to increase further during the second half of 2018, after the latest OPEC agreement in July 2018 to increase the oil output. As per IMF estimates, Saudi Arabia's oil production would average 10.3 mbpd (up from 9.9 mbpd in the first six months), effectively reducing the expected budget deficit to around USD 30 bn, from previously projected USD 52 bn.

SAMA hikes key interest rate as anticipated, in tandem with US Fed hikes

In an unprecedented move on March 15, Saudi Arabian Monetary Authority (SAMA) raised its repo and reverse repo rates by 25bps each, to 2.25% and 1.75% respectively ahead of the anticipated US Fed rate hike, which eventually happened on March 21. While the reverse repo rate was being raised over the past two years in line with the Fed rate changes, this was the first time since 2009 that Saudi Arabia changed the repo rate. We had anticipated the rise in interest rates due to pressure from strengthening US Dollar and the concerns of capital flight or deposits being shifted to USD from SAR. SAMA raised the key rates by 25bps once again on June 13, following US Fed rate hike to the range of 1.75%-2% during that month. Saudi repo and reverse repo rates now stand at 2.5% and 2% respectively. While increasing interest rates remain a moderate concern for economic growth, credit rating agency Moody's said that the rate hike by SAMA is credit positive for the Saudi banking system as it would help prevent Saudi investors' and depositors' capital outflows and positively reflect the Saudi banking system's stable liquidity conditions.

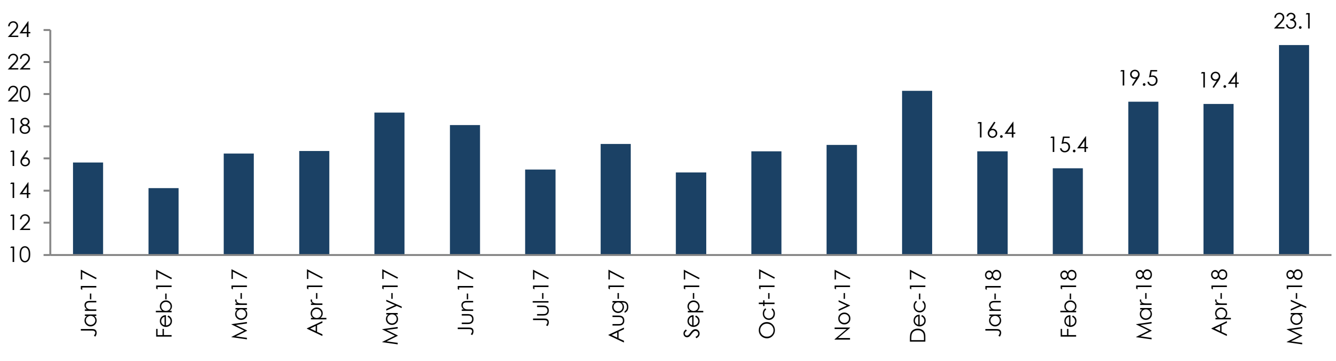
Saudi government debt issuance rises in 2018

We viewd that Saudi Arabia has a sizable room for debt issuance in 2018, with 2017 debt-to-GDP ratio at 17.3%, which is on the lower than other GCC nations and Emerging Markets peers, and also well below the cap of 30% the government has put according to fiscal rebalancing program. The fiscal deficit for Q1 2018 was mainly financed through issuance of debt amounting to SAR 41 bn (~USD 11 bn). Saudi Arabia further raised USD 11 bn from international bond market, in what was the biggest emerging market bond sale of 2018 at that time. The bond issue received more than USD 50 bn in bids, showing growing investor confidence in Saudi economy. The Saudi government plans to raise a total of USD 31 bn through bonds this year, compared to USD 21.5 bn raised in 2017 and USD 17.5 bn raised in 2016.

Consumption improved on government support

We had anticipated Saudi domestic consumer spending to improve during 2018, supported by higher government spending. This has largely been the case, with both POS transactions and ATM withdrawals rising on a YoY basis for every month in 2018 (latest data available till May 2018). The rising consumption was supported by SAR 50 bn fiscal stimulus program announced at the end of 2017 in the form of allowances and tax breaks, as well as increased government spending on employee compensation and social benefits during Q1 2018. During the first two months of 2018, improving consumption was partially offset by increased costs of utilities and fuel as well as impact of newly introduced VAT. However, after the initial impact of these factors waned, consumption has increased more sharply, as evident by high double digits percentage growth in POS transactions on YoY basis during the March to May, reaching all-time high of SAR 23.1 bn in May.

Figure 3: POS Transactions Sales (SAR bn)



Source: SAMA

Saudi stock market on the rise

Saudi Arabia's stock market is significantly on the rise in 2018, with Tadawul All Share Index (TASI) up 15.8% YTD in 2018 so far (as of July 26th). Rising oil prices, as well as other anticipated positive developments such as Saudi Arabia's inclusion in Emerging Market Indices by FTSE and MSCI, and positive earnings growth trajectory in Q1 2018 have supported TASI's gains so far this year.

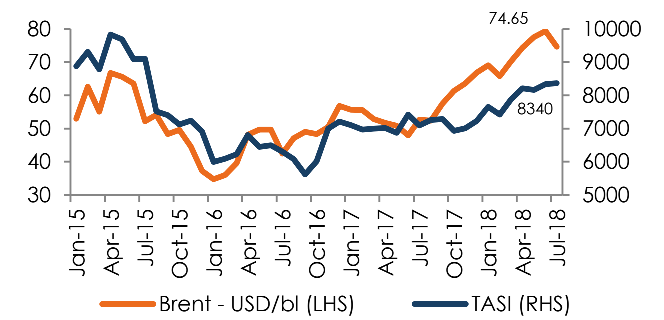
Impact of EM inclusion by FTSE and MSCI

Upgradation of Saudi Arabia to Emerging Market status first by FTSE in March and then, more importantly by MSCI in June, played a key part in the upsurge of TASI. The anticipation and realization of both the decisions have contributed to record net foreign inflows into the Saudi equity market this year (SAR 16.6 bn by the end of June 2018). The total foreign ownership in Tadawul has also increased to 5% by the end of June from 3.4% in January 2018.

Positive corporate earnings growth trajectory

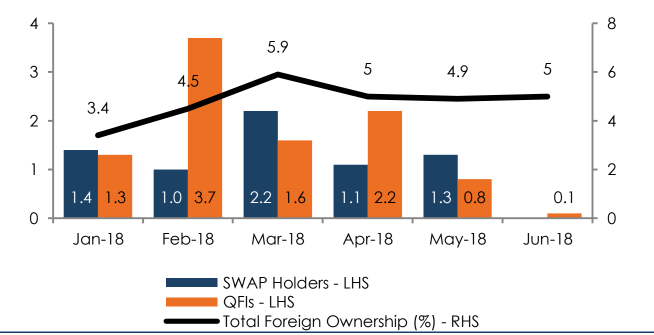
We had expected positive growth trajectory for quarterly corporate earnings during 2018. Earnings recovered well during Q1 2018, after a tepid Q4 2017 performance, with ex-utilities sector* earnings growth at 4.4% YoY and 28.4% QoQ. Aggregate net profit margin also improved to 15.1% from 9.2% in Q4 2017. The energy sector recorded the highest growth in aggregate earnings (183% YoY), on the back of sustained increase in crude oil prices during the quarter. Petrochemicals stocks also performed well due to improved global economic conditions resulting into higher demand and higher selling prices for most of their products. Banks did well (7.4% YoY aggregate earnings growth) on lower interest expenses and provisioning charges.

Figure 4: TASI vs Oil



Source: Tadawul, Bloomberg

Figure 5: Net value added by SWAP and QFIs, Total Foreign Ownership (%) in Tadawul



Source: Tadawul

Subdued IPO action

IPO activity, however, remains subdued, with the much anticipated listing of Saudi Aramco looking unlikely in 2018, and no other major listing taking place during the year (except REITs). The one IPO in pipeline is of Leejam Sports, which is scheduled to take place during the first week of August, and expected to raise SAR 1 bn (USD 267 mn).

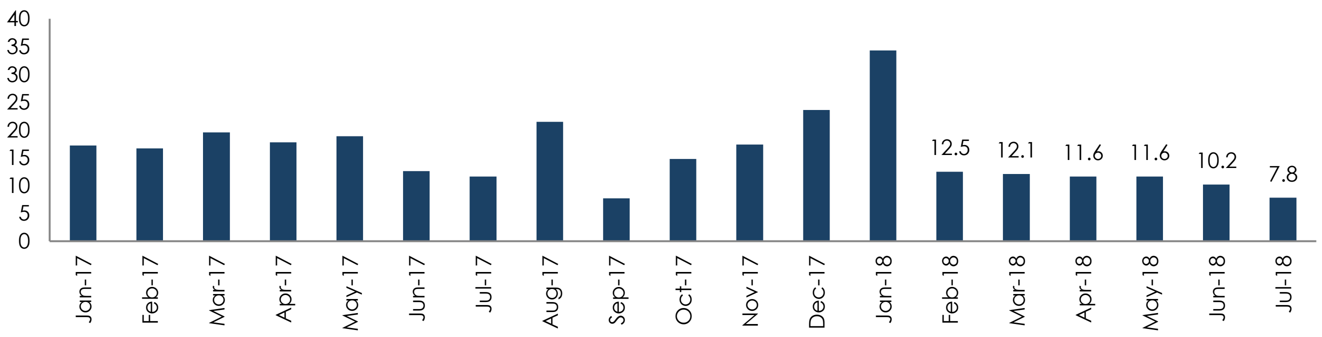
**Utilities sector is excluded to avoid negative outlier effect of Saudi Electricity Co's earnings (net loss of SAR 1.2 bn), as the company accounts for 98% of the sector's total market capitalization*

Real estate sector subdued

We had been cautious in Saudi Arabia's real estate sector outlook in 2018, and the sector seems to be subdued so far in 2018. There has been 1.2% YoY fall in Real Estate Price Index (provided by General Authority of Statistics) in Q1 2018. The total value of real estate transactions from January to July 2018 has declined 32% YoY to SAR 65.8 bn, compared to SAR 97.2 bn during the same period in the previous year. Construction activity also seems subdued, going by the fact that cement sales volume during the period of January to May 2018 fell 13% YoY and cement prices were also down 11% YoY during Q1 2018.

However, REITs market was somewhat active as expected, with four new listings of REITs on Tadawul, taking total market capitalization of REITs above USD 2 bn, compared to USD 1.77 bn at the start of the year.

Figure 6: Total Value of Real Estate Transactions (SAR bn)



Source: Argaam

Infrastructure Sector: Draft PPP law released for public review

Public Private Partnerships (PPPs) are a tool for investors and corporates to access part of the market previously only accessible to the government. During early July 2018, Saudi Arabia released a draft law for PPPs for public comments for three weeks, ending July 29th.

In our KSA 2018 Outlook report we had said "*The legal and regulatory frameworks in Saudi Arabia continue to evolve and develop to provide an environment that would encourage and facilitate the use of the PPP model. There are some challenges to overcome, but significant progress was made in the last 18 months. The public and private sectors show substantial interest in PPPs. The developing phase of the legislative structure did not discourage early investors and developers from entering the PPP market to explore potential opportunities in real estate, but some concrete steps would be needed in the near future to maintain the momentum.*" (Page 24, KSA 2018 Outlook)

In late April, the Saudi government announced plans to generate around USD 9—11 bn in revenues by 2020 through a privatization program which would consist of 14 different PPP investments worth USD 6.4—7.4 bn, creating about 12,000 new jobs in the process.

The draft PPP law creates a framework to allow companies to bid for PPP contracts within a 10-day period though the government entity's website or National Centre for Privatization's (NCP) website. The text of the draft law states that companies involved in PPPs may be exempted from rules regarding ratio of Saudi nationals employed as per Saudization scheme. It also states that rules regarding foreign real estate ownership would be relaxed as well.

Conclusion

The first half of 2018 saw a combination of positive news and developments in terms of the economy as well as equity markets. We were glad to note that several of our expectations came true. We expect the Saudi economy to build further on this base and continue to improve, although at a gradual pace. Steady oil prices and export volumes, consistent budgeted spending throughout the year, moderate inflation and consumer sector adjusting to price increases due to reduced subsidies and new taxes, will help the economy grow in a sustained manner. Barring any sudden shocks, we expect the known risks to be mitigated through various measures by the government and monetary authority, and thus continue to have a positive outlook overall on the economy.

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