

Saudi Public Market Outlook in light of the Global Pandemic and New Global and Local Macroeconomic Realities

COVID-19 resulted in an unprecedented crisis for the world economy and escalated volatility for global capital markets. Many economies were already slowing before the pandemic, and COVID-19 was the tipping point driving world economies into a sharp recession and potentially a depression. Globally, governments and central banks implemented substantial fiscal and monetary stimulus measures to mitigate the disruption caused by the pandemic. Looking at some nameplate stock market performances, one would think this global pandemic was a positive catalyst for the global economy!

Our part of the world, and Saudi in particular, was not any different with an even sharper contrast between market performance and economic outlook considering oil price correction and the contractionary economic measures adopted by the government.

USA: Wall Street vs. Main Street

In the USA, the immediate impact of COVID-19 was a stock market crash in March. On Main Street, the impact was seen in the cash flows of corporations, which resulted in furloughs and layoffs with around 39 million jobless claims within 9 weeks (the highest level of unemployment in US modern history at 14.7%)¹. Direct intervention by the government and the Federal Reserve added trillions of dollars into the economy to alleviate the burden on American citizens and corporations. With a liquidity flush from the Federal Reserve and treasury programs (the Fed intervening directly in the bond markets), the US stock market recovered and is currently at an all-time high, having discounted the impact of the pandemic and priced in a full swing “V” shaped recovery - which factors in a vaccine for COVID-19 and almost argues for a better outlook for the global economy, discounting any risk and uncertainty. Additionally, current market levels seem to ignore the risks associated with the upcoming US presidential elections, residual unemployment after COVID-19, political and social instability - where riots demanding racial equality ensue, and the dangerous rhetoric with China (the tune the market was dancing to in Q4 2019 and before COVID-19). In only 6 weeks, polls favoring Trump have shifted to Biden in what now seems like a tight race. This poses challenges for Wall Street- albeit ignored for now, given the potential impact on corporate taxes, the level of reliance on the Federal Reserve for asset purchases and any support for Main street.

Saudi Arabia... riding the wave of optimism

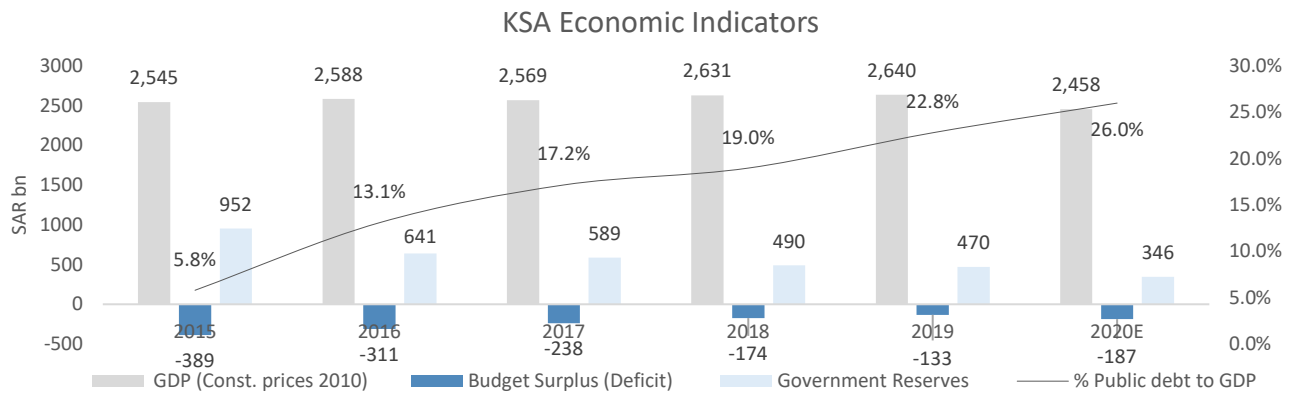
Like the rest of the world, COVID-19 containment measures caused significant economic turmoil in the Kingdom, which suffered from a double whammy due to plunging oil revenue (which represents 64% of budget revenues, 40% of GDP, and 75% of export earnings)² on the back of production cuts following the drop in global demand for oil. Despite serious ongoing efforts to diversify its economy away from petrochemicals (non-oil revenues became meaningful in 2018, representing 33% of total revenues)², KSA remains a resource-based economy which is still heavily dependent on oil as a tool to finance economic diversification efforts.

¹ Source: U.S. Bureau of Labor Statistics

² Source: Saudi Arabian Monetary Authority Statistics

Although KSA boasts strong fiscal and external balance sheets, including exceptionally high international reserves and low government debt, over the last few years, the Kingdom's fiscal and external balance sheets have been deteriorating, and the downturn in oil prices has accelerated this trend (5.8% debt to GDP in 2015 to 24.1% in 2019, and a first half deficit already catching up with the originally-budgeted 26% figure for 2020 with a debt ceiling approved to 50% for 2020)³. Given the impact of the pandemic and oil revenue on the kingdom, The IMF revised real GDP growth from 1.9% to -6.8% in 2020⁴.

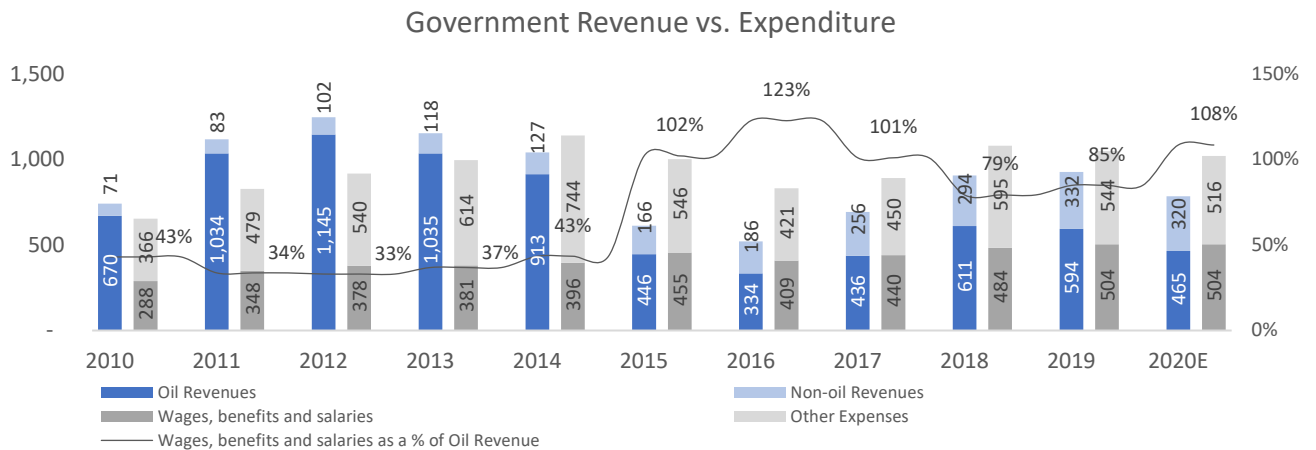
Fiscal leeway still available for Saudi despite increasing public debt, diminishing government reserves, and contracting GDP in 2020



Source: Saudi Arabian Monetary Authority, Ministry of Finance Budget Statement, IMF

Since 2014, government expenditures exceeded oil revenue, and in some years, wages, benefits, and salaries alone exceeded 100% of oil revenue (as witnessed in 2016). The shortfall has been ploughed with debt issuances considering the high leverage ability of the Kingdom.

Addressing the public wage bill and improving non-oil revenues are key for the fiscal health of the Kingdom



Source: Saudi Arabian Monetary Authority, Ministry of Finance Budget Statement, Amwal Capital Partners Estimates
 * 2020 Oil Revenue is estimated by Amwal Capital partners to be between SAR 430bn and SAR 500bn. Ministry of Finance budgeted figure is SAR 513bn

³ Source: Saudi Arabian Monetary Authority, Ministry of Finance Budget Statement
⁴ Source: IMF

The need to maintain the currency peg (which provides the framework for monetary policy) limited the Kingdom’s dry powder in the policy space and diminished ability of SAMA to use monetary tools to manage the crises – unlike other central banks which have floating currencies. As such, to contain the damage caused by the pandemic to the economy, the Saudi government opted for a combination of limited expansionary policy tools, as well as targeted austerity/ protectionist measures to manage its deteriorating fiscal balance.

While in the US, stimulus measures revolved around flooding the market with liquidity directly through monetary handouts to individuals, businesses, cities, and counties and indirectly through supporting lending institutions and quantitative easing, Saudi targeted relief towards the private sector by subsidizing a large part of Saudi employee salaries, deferring the payment of certain fees, funding lending programs and providing SMEs and banks with liquidity.

The below table contrasts stimulus in the US vs. stimulus in KSA.

	USA	KSA
Interest rates	<ul style="list-style-type: none"> - The Fed cut its benchmark interest rate (Fed funds rate) by a total of 1.50%, which lowered the fed funds rate from 1.50%-1.75% to 0.00%-0.25%. - The Fed also cut its discount rate by 1.5% down to 0.25%. 	<ul style="list-style-type: none"> - SAMA cut both the Repo and Reverse Repo rates by a total of 1.25% (Repo rate 2.25% to 1%, and Reverse Repo rate from 1.75% to 0.50%).
Quantitative easing	<ul style="list-style-type: none"> - The Fed commenced a round of quantitative easing (at least by USD 0.7 trillion) by purchasing government bonds, commercial mortgage backed securities, and other long-term securities. 	N/A
Regulatory and Financial support	<ul style="list-style-type: none"> - Supported banks in using inaccessible funds from their capital requirements (Total Loss Absorbing Capacity) to lend to those impacted by COVID-19. - Reduced reserve requirements of smaller lenders to zero. - Delayed the implementation of Foreign Banking Organization Maximum Daily Overdraft Rule and scaled back non- critical oversight - Provided reporting relief for small financial institutions - Allowed banks to adopt early “a standardized approach for measuring counterparty credit risk” and delayed the implementation “current expected credit loss” which adversely impacts how banks calculate losses - Postponed Bank control framework- which determines what constitutes control/ ownership within a bank. - Loosened leverage ratios on banks to free up capital so that lenders provide the economy with credit. - Implemented the CARES act, which contains several provisions decreasing the regulatory burden on banks 	<ul style="list-style-type: none"> - The government announced a USD13.3 billion Private Sector Financing Program, aimed at mitigating the impact of COVID-19 on the private sector, especially MSMEs. The program consists of: <ol style="list-style-type: none"> 1. USD 8 billion to banks and financing companies to delay loan payments due from SMEs for six months. 2. USD 3.5 billion to SMEs through bank loans to help them to continue operations and support growth. 3. USD 1.6 billion to SMEs as a loan guarantee program. - SAMA injected USD 13.3 billion into the banking sector to enhance banking liquidity to continue providing credit facilities for the private sector; - Other measures introduced by the government include: <ol style="list-style-type: none"> 1. Paying 60% of the salaries of Saudi employees working in the Private sector for a period of three months with a ceiling of USD 2.39 billion. 2. Exempting expatriates whose residency ended from the necessary financial requirements needed for visa renewal for a period of three months. 1. Enabling employers to extend/ recover unused exit and return visas for expatriates during the entry/exit ban.

to free up capital that can then be made available to businesses through:

1. Paycheck Protection Program Liquidity Facility (PPPFL), that will purchase PPP loans from lenders, allowing banks to continue lending under PPP, removing non-performing loans from the balance sheets of private industry and expanding access to non-depository lenders
2. The Main Street Business Lending Program, which purchases USD 600 billion of debt from companies employing up to 15,000 workers or with revenues above USD 5 billion;
 - The Municipal Liquidity Facility which purchases USD 500 billion of debt from states, cities and counties with populations of at least 250,000.
2. Enabling business owners to delay paying VAT, selective goods tax and income tax and zakat owed.
3. Postponing the collection of customs duties on imports
4. Postponing the payment of some government service fees and municipal fees due on private sector establishments
 - Social Development Bank issued a USD 3.5bn initiative to support citizens, families and small establishments to cope with COVID-19's economic impact.

Contractionary/ Protectionist/ Austerity measures	N/A	<ul style="list-style-type: none"> - KSA will cancel, extend, and postpone some operational and capital expenditures for government agencies, and reduce provisions for a number of initiatives from its Vision 2030 and major projects for the 2020 fiscal year - Discontinuation of the cost of living allowance (USD 9.3 bn) for public servants (USD 267 per individual per month) in June 2020. Financial benefits paid to public sector employees and contractors will also be revised. - VAT rate increased by 300% from 5% to 15%, effective July 1, 2020. - Increase in import tariffs on select products (including select agriculture and FMCG)
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Source: Amwal Capital Partners Analysis

Although Saudi tried to alleviate the impact of the pandemic by supplying the market with liquidity -to its best ability - it counteracted its stimulus measures by imposing contractionary and protectionist policies.

The Saudi Stock Market – Tadawul

TASI's YTD performance as at the end of August is -4.6%⁵ after recovering from a trough of -30%⁵ on March 16. This recovery and the current valuations (LTM P/E of 28.3x)⁵ given a GDP contraction of 1%⁶ in Q1 and an even sharper decline expected in Q2 is not justified in our view, especially taken in the context of Saudi's limited ability to boost liquidity (due to the currency peg, Saudi cannot print money like its European and American counterparts, which arguably played a large part in the recovery of their respective stock markets), and the austerity measures put in place. While seen as overdue and warranted, the removal of the cost of living allowance for public servants is imperative for achieving fiscal consolidation. Further, a 300% increase in VAT (from 5% to 15%)⁷ - a bold move considering that VAT was only introduced in 2018 - imposing custom duties on imports, and a prospective second wave

⁵ Source: Bloomberg

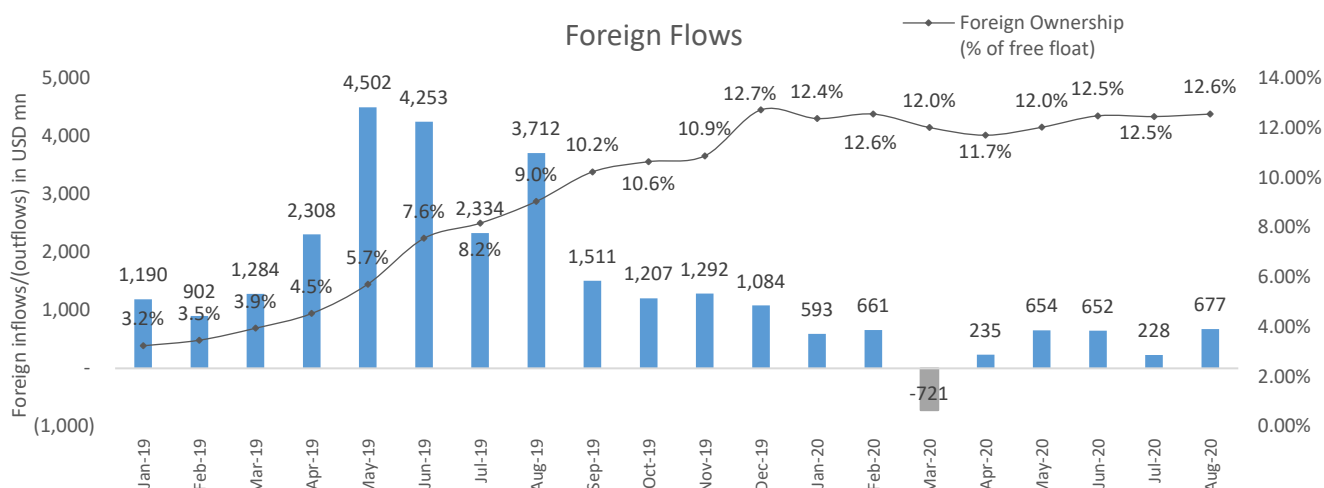
⁶ Source: Saudi General Authority of Statistics

⁷ Source: Saudi Ministry of Finance

of expat exodus (resulting in a 5% contraction in Saudi’s population)⁸ due to job losses in the Kingdom will create a demand shock and weigh down heavily on consumer spending.

In addition, while EM markets broadly benefited from global liquidity, and since main MENA markets do carry now a considerable collective weight in the MSCI EM index (estimated at 3.9% with Saudi at 2.5%)⁹, the low liquidity profile of MENA markets make them susceptible to a considerable flow impact, especially given the liquidity abundance and appetite of dollar investors (seeking US dollar “like” denominated equities), as well as the underweight positioning by EM investors. The chart below illustrates the inflow from foreign investors into the Saudi market and their ownership of free float¹⁰.

Global liquidity had a clear impact on the Saudi market with heavy buying from foreign investors



Source: Tadawul

We have so far observed a YTD net inflow of c. USD 3.4bn¹¹ into the Saudi market as of August 2020 despite the harsh impact of the COVID-19 crises on its fiscal outlook. Foreign inflows into the market over the second quarter completely discounted oil and its impact on Saudi’s fiscal position, Saudi’s budget measures, and its corresponding implications on consumption and corporate earnings.

To the extent that global demand remains low and oil production cuts continue (mitigating the recovery in Brent prices, since KSA’s oil revenue from 5.7 million barrels sold at c. USD 40 per barrel in May and June is almost equivalent the revenue of 9 million barrels sold at c. USD 25 per barrel in March and April)¹², KSA will have to continue in its efforts to achieve needed fiscal discipline through reduced spending and more austerity measures. This will add pressure to consumer spending on the short to medium term, and potentially economic growth on the longer term, should the CAPEX cuts impede the Kingdom’s diversification plans.

To illustrate the distortion in valuations vis-a-vis market fundamentals, below is a chart showing TASI’s P/E relative to MSCI EM, MSCI Arabia and other regional markets.

⁸ Source: A study by Riyadh based Jadwa Investments

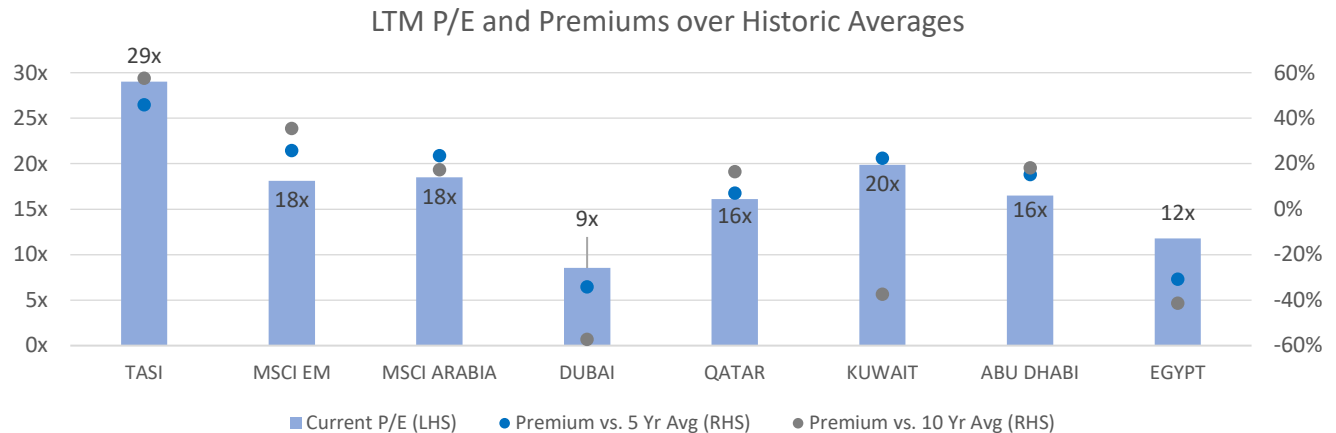
⁹ Source: MSCI

¹⁰ Foreign ownership as a percentage of free float is estimated from January until November 2019 as published figures are calculated using a different methodology

¹¹ Source: Tadawul

¹² Source: Bloomberg

TASI is trading at a hefty premium over its historical mean and that of other regional & EM markets (which boast more favorable macroeconomic outlooks)



Source: Bloomberg

* Kuwait premium is calculated against its 5-year and 7-year P/E average due to data limitations

Despite the limitation in just looking at the P/E multiples of a market, it is fair to say that even given the weakened outlook for the Saudi economy, the stock market is still trading at a large premium relative to other EM and regional markets (with arguably better economic outlooks). Further, although most markets today are trading at higher multiples than in previous years, the Saudi market is trading at a much higher premium to its own 10-year and 5-year P/E average. Hence, the 4.6% drop in the overall market this year (up until the end of August) does not reflect the reality facing the economy - and subsequently many corporates - a few years down the line.

That said, the significant changes in the economy are resulting in pockets of opportunity for investors, with some sectors set to benefit. Below is a list of sectors that are set to benefit in the years to come:

Insurance: Remains a heavily underpenetrated sector with several positive catalysts that would help the insurance pie grow in Saudi and close the gap with global economies (2% of GDP¹³ in Saudi vs. 9%¹⁴ OECD).

- The enforcement of the Third-Party Liability on cars (only 45% of cars in Saudi are estimated to have TPL) should increase the market size of motor insurance and reduce the claims per insured car as less fraud is committed. We expect this catalyst to unlock significant value in the sector.
- The drive by SAMA to consolidate the market (via larger equity base requirements and making it harder to issue capital for weaker franchises), should result in a few, much larger, strong players.
- SAMA's drive to introduce new lines of mandatory insurance (similar to the Defects Liability Product) will help increase the P&C market.
- Life insurance might take some time to grow but will do so from a very low base.

Healthcare: The active enforcement of health insurance as well as the privatization drive by the government to reduce public sector expenses and improve efficiency will help the large players with solid

¹³ Source: Fitch credit ratings agency

¹⁴ Source: OECD Insurance Statistics 2019

balance sheets in the sector that deliver very good quality of service to continue to grow organically and inorganically (partly through government corporatization programs that could be happening very soon).

Consumer (Discretionary and Staples): Benefits the larger players from a consolidation drive. With lower consumer spending due to VAT implementation and the suspension of the cost of living allowance, as well as an expected expat exodus, the sector is poised for a consolidation drive whereby select larger players with stronger balance sheets are better poised to weather the storm and embrace modern retail channels (such as online stores) driving the smaller players out of the market.

Tourism, Hospitality & Entertainment: The entertainment sector is viewed as a key lever in the country's diversification drive and is starting from a very low base. Post COVID-19, these sectors are expected to witness huge growth from the resumption of the religious tourism as well as the non-religious tourism drive.

Below is a summarized view on the outlook and valuation of the various sectors in Saudi

Sector	Outlook	Valuation
Banks	<ul style="list-style-type: none"> - Lower interest rate environment impacting NIMs - Higher Cost of Risk due to a weaker business environment - Expected delay project lending (cut in capex) 	<ul style="list-style-type: none"> - Valuation of banks doesn't fully reflect the impact on the NIMs in the medium term, and doesn't take into account any risk from increased provisions due to weaker economy
Petchems	<ul style="list-style-type: none"> - Competitive environment increasing for Saudi ethane producers losing their competitive advantage 	<ul style="list-style-type: none"> - Valuations very elevated and do not reflect the outlook of the product prices and the new normal profitability of the petchem firms
Telecoms	<ul style="list-style-type: none"> - Very defensive but maybe impacted by the expat exodus and the resulting price competition on services. 	<ul style="list-style-type: none"> - Valuation fully prices in the defensive and 'cash cow' nature of the sector
Insurance	<ul style="list-style-type: none"> - Positive outlook considering expected overall market growth <ul style="list-style-type: none"> - SAMA's drive to introduce new lines of mandatory insurance (similar to the Defects Liability Product) will help increase the P&C market. - Enforcement of motor insurance (<50% of cars insured) - Negative impact from investment income due to lower rates - The drive by SAMA to consolidate the market should result in a few, much larger, strong players. 	<ul style="list-style-type: none"> - Attractive valuations for well run companies that are expected to witness huge growth over the coming years
Healthcare	<ul style="list-style-type: none"> - Active enforcement of health insurance as well as the privatization drive by the government will help the large players to grow organically 	<ul style="list-style-type: none"> - Several healthcare companies more than fully reflect the growth expected, while some attractive opportunities exist in turnaround / ramp up companies with huge capacity expansions coming online

Consumer Staples	<ul style="list-style-type: none"> - Limited growth due to a decline in consumer purchasing power and expat exodus - Will embrace modern retail channels (such as online stores) - Players with stronger balance sheets might benefit from a consolidation drive, driving smaller player out of the market. 	<ul style="list-style-type: none"> - Valuation fully prices in the defensive and nature of the sector
Consumer Discretionary	<ul style="list-style-type: none"> - Weaker discretionary income for households given austerity measures and increase in VAT - Will embrace modern retail channels (such as online stores) - Players with stronger balance sheets might benefit from a consolidation drive, driving smaller player out of the market. 	<ul style="list-style-type: none"> - Valuations don't take into account the risk of a significant reduction in disposable income that could impact sales and profitability of all discretionary players, despite the expected increase in market share of the large ones
Entertainment & Hotels	<ul style="list-style-type: none"> - Government push to grow this sector to reduce dependence on oil and after Corona, may witness further domestic travel and entertainment as international travel may be more challenging 	<ul style="list-style-type: none"> - Not many direct plays on the sector, however some attractive opportunities could emerge once normalcy starts to return
Transportation	<ul style="list-style-type: none"> - Sector impacted by overall macro-economic activity in the country - Several sub sectors (such as car leasing) will witness consolidation with larger companies gaining market share 	<ul style="list-style-type: none"> - Some attractive plays in select businesses and franchises with competitive advantages
Cement, Construction, Building Materials	<ul style="list-style-type: none"> - Projects still ongoing however negative impact to show over the medium to long term as heavy capex projects will be the first to suffer the consequences of fiscal discipline 	<ul style="list-style-type: none"> - The sector doesn't reflect the weak capex outlook in the country

Source: Amwal Capital Partners Analysis

As a Final Take

- ***The long-awaited economic reality is finally hitting resource dependent KSA. The establishment of critical and urgent fiscal discipline reforms is finally taking place and is accelerated by the impact of COVID-19 on the Saudi economy.***
- ***Notwithstanding the global bull run led by the US markets, from a fundamental point of view, there should be a correction in the Saudi stock market, which is currently driven by a liquidity induced global rally despite a different reality on the ground. We expect future earnings, geopolitical tensions and a US election that has direct ramifications on the region to be potential catalysts for a correction back to normalcy.***
- ***Yet, similar to 2016, some sectors should benefit from these fiscal measures (insurance, etc.) and the implementation of vision 2030, to accelerate the modernization of the Saudi economy.***

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