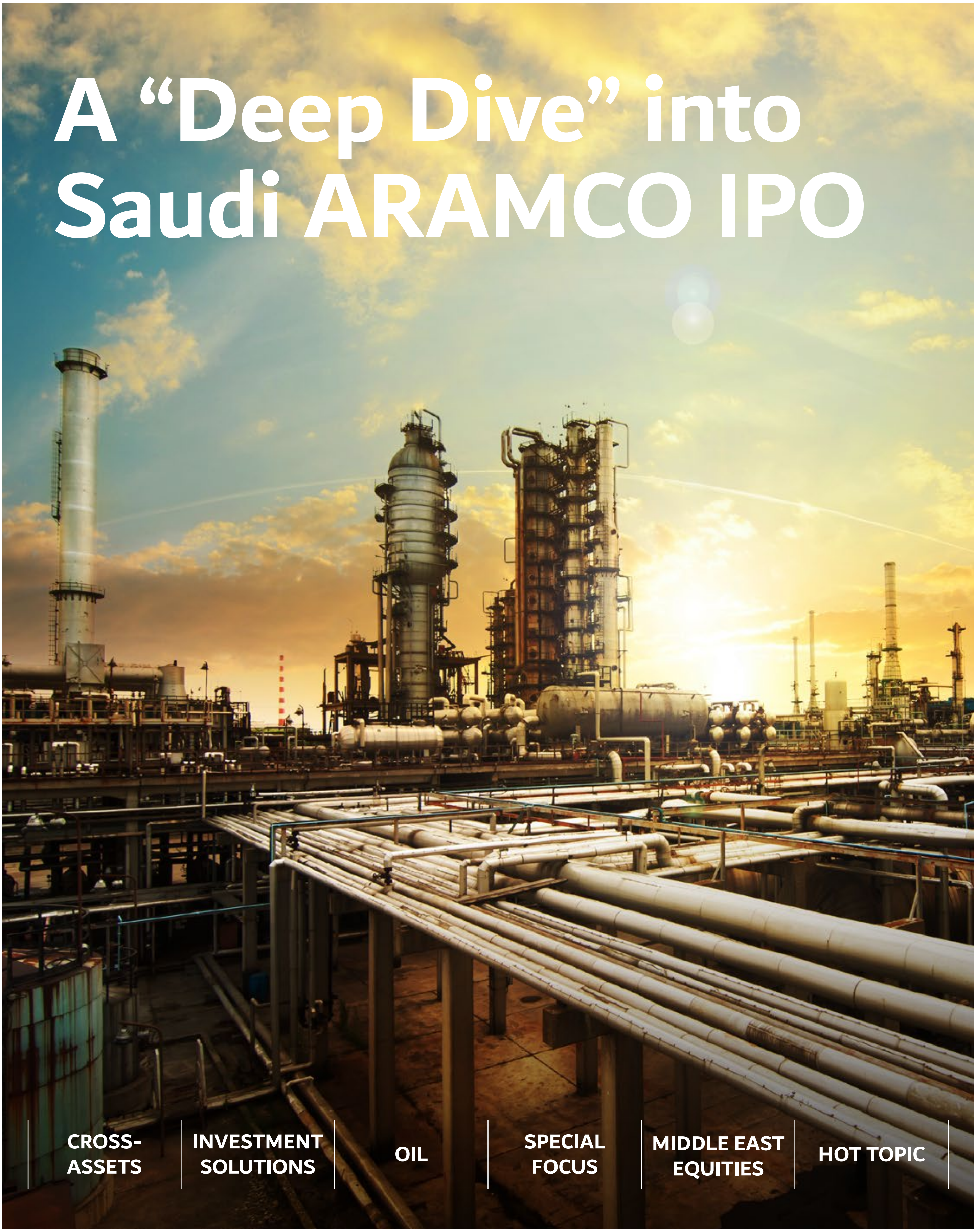
Perspectives

Al Mal Capital

March **2018**

A "Deep Dive" into Saudi ARAMCO IPO



CROSS-ASSETS | INVESTMENT SOLUTIONS | OIL | SPECIAL FOCUS | MIDDLE EAST EQUITIES | HOT TOPIC

Contents

Welcome to the 13th edition of Perspectives.

After 18 months of extraordinary calm on the markets, volatility returned these past few weeks. The primary culprit has been an inflation fear. In the first section, we explain why the correlation between equities and bonds is flipping. This has important implications for portfolio construction as investors need to look for new diversifiers. In light of this, we look at Copper, as the red metal historically performed well in the context of rising inflation. Staying with commodities, we highlight why we believe US shale rise is overshadowing some of the strong factors that play in favor of Crude Oil.

Moving to the MENA region, the Special Focus of the month is on the Saudi Aramco IPO. We attempt to answer some key questions surrounding what is expected to be the largest public offering ever. Still in Saudi, we revisit our bull case on the banking sector. The last section is about Lebanon, a country which is facing some daunting challenges.

We hope you will enjoy this issue.

Cross-assets:

the most important correlation is flipping

At the time of our writing, US equities continue to consolidate after the -11% drawdown observed in early February. After 14 consecutive months of positive return for the S&P 500, a correction was long due. As we explained in the January edition of Perspectives, we expect 2018 to be a positive one for equities but with more volatility than in 2017. Below, we attempt to analyze the fundamental and psychological drivers behind the market pullback and the way various asset classes are behaving over this period. Assuming that a market regime change is happening, we look at the main implications in terms of portfolio construction and asset classes' preferences.

An "inflation fear" is behind the recent "Risk-off" development

Since the recovery of global equity markets in 2009, the vast majority of equity corrections was triggered by a "growth/deflation" fear. Given the slow pace of economic recovery and ballooning debt levels, market participants felt uncomfortable each time some macro indicators were pointing towards a risk for the global economy to move back into recession or deflation.

Last year was characterized by a "goldilocks" situation where global growth (and company earnings) were reaccelerating without any pick-up in inflation. This conundrum allowed global central banks to stay accommodative despite surging asset prices across most world exchanges.

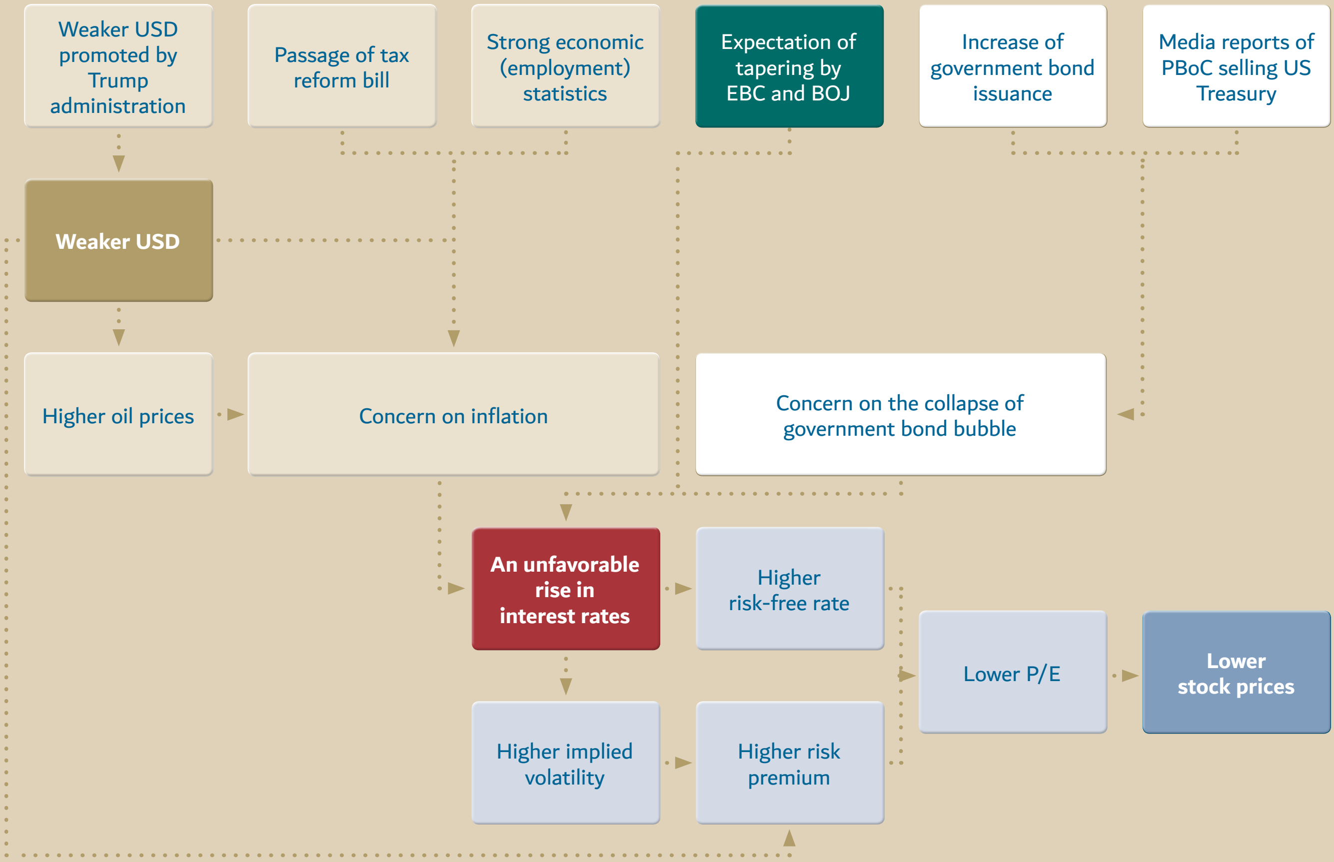
As discussed earlier, we believe that 2018 might prove different than 2017 in the sense that global economic growth is accelerating to a level which is creating some inflation pressures. This change of paradigm is incentivizing the US Federal Reserve, the ECB and more recently the Bank of Japan to either increase rates or change the pace of their asset purchase programs. As investors have been addicted to zero interest rates and quantitative easing, this change of regime should lead to a more volatile environment than in 2017.

This is precisely what seems to be happening in the first quarter of this year. To be more precise, a confluence of various elements is creating an "inflation fear". As shown on the figure on the next page (courtesy of Deutsche Securities), the weaker dollar, US fiscal reform, higher oil prices and stronger employment figures are all nurturing the sentiment that inflation will rise more than expected. This has been weighing on benchmark bond yields which are breaking important psychological levels. The rise in bond yields is not only triggered by the inflation fear; the expectation of tapering by ECB and BoJ, the increase of US government bond issuance to finance the budget deficit and media reports that the central bank of China is selling US treasuries are creating some concerns that the government bond bubble could collapse.

Rising interest rates and bond yields do have some consequences for equity markets multiples. A higher risk-free rates and higher risk premium induced by higher implied volatility justify lower P/E's and thus lower stock prices.

Weaker dollar, US fiscal reform, higher oil prices and stronger employment figures are all nurturing the sentiment that inflation will rise more than expected.

Risk-off development led by anticipations of an unfavorable interest rate hikes



The leadership observed within US equities during the recent correction seems to validate the reasoning above. Over the last few years, defensive sectors were the most resilient during market pullbacks. Indeed, "growth / deflation fears" led market corrections used to push investors towards government bonds. On the equity side, interest-rate sensitive sectors such as Utilities, Telecoms and REITs logically outperformed the rest of the market during drawdowns. But in this new market context, leadership is changing. As government bonds prices fell in sync with equities during the latest correction, the traditional "safe-haven" sectors actually underperformed the more cyclical ones such as Consumer discretionary, Technology or Banks.

Is it time to take profit or is the equity bull case intact?

Coming back to the "inflation fear", the very important question is indeed if the rise of inflation could lead to more downward pressure on multiples and thus further damages to equities.

Looking at history, it is important to highlight that there is a non-linear relationship between yields and multiples, i.e. the relationship changes depending on the level of inflation (see chart on the next page).

Inflation and equity multiples are more likely to rise in tandem when inflation (and ultimately interest rates) are rising from unusually low levels, as is the case today. Under these circumstances, faster growth is treated as a positive as it alleviates recession and deflation fears. In addition, faster nominal growth is also associated with faster earnings growth (as it is the case right now).

Unfortunately, there is a caveat. Rates/inflation and valuations can rise together, but up to a certain point. Indeed, for a given level of inflation, the negative relationship between rates/inflation and valuations reasserts itself. In other words, at a certain level higher bond yields create real competition for stocks, particularly dividend stocks, and put downward pressure on multiples.

With this in mind, the next question is where is the inflection point in terms of benchmark bond yields? While some have suggested 2.75% or 3.0%, the latest and greatest estimation of this inflection point came from Credit Suisse last month, which calculated that the day of reckoning for stocks will take place just as the US 10 year yield hits 3.50% - Stay tuned.

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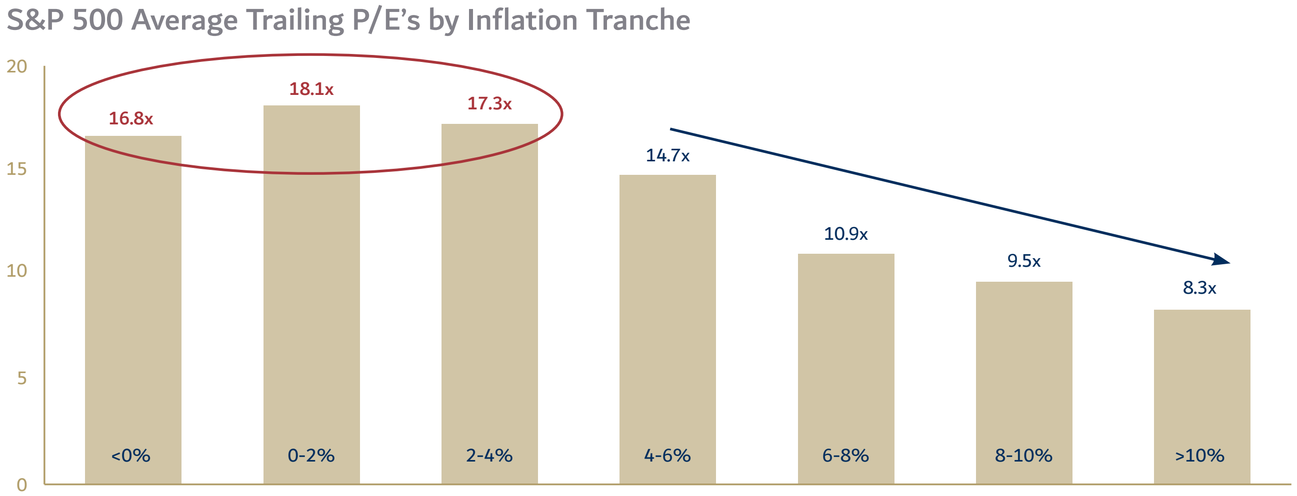
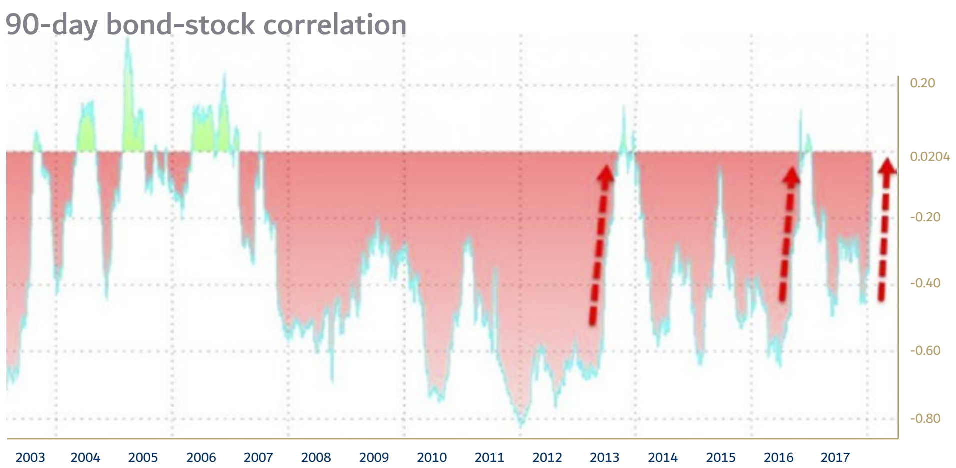


The market most important correlation seems to have flipped

The fact that a linear relationship between bond yields and equity multiples seem not to be too far away has triggered a very important event on the market. Indeed, a key feature of the recent equity markets correction has been the variation of correlation between bond and stocks.

Looking at history, the relationship between bonds and equities was generally positive for most of the 1960s through the 1990s (i.e. lower bond prices and thus higher yields were bad for stocks), a period during which the average level of rates was 7.5%. But since the turn of the century, the relationship was generally negative (lower bonds and thus higher yields good for stocks) a period during which the average level of rates was 3%. The relationship between rates and stock returns troughed about five years ago, but has remained negative though less so since the recent low in late 2015. But more recently, we have seen the bond-stock correlation moving from negative to positive (see chart below).



Conclusion

From the above, asset allocators across the world now need to reconsider their portfolio construction approach. The use of long duration bonds as a diversifier for the riskier part of global portfolios might not be effective as in the past. Consequently, portfolio managers now need to look at market instruments which can protect the portfolio in case of an acceleration of inflation.

We highlight one of them in the next section.

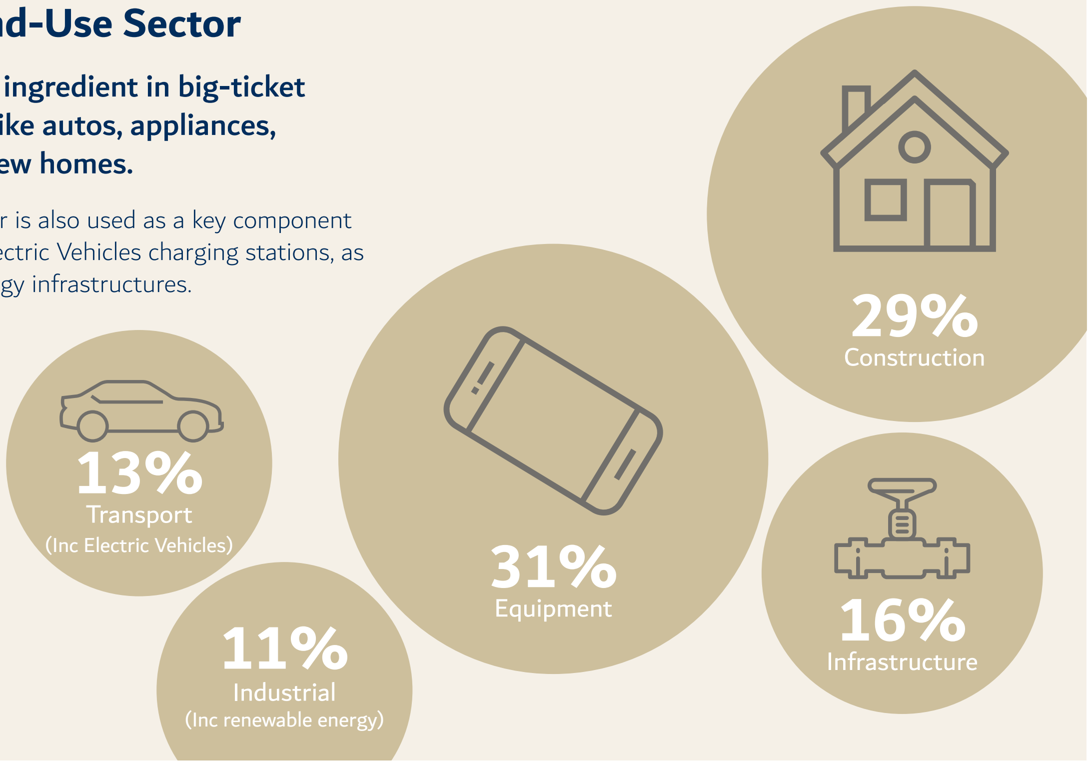
Inflation fears? Think about Dr. Copper

As mentioned in the January edition of Perspectives, commodities is an interesting asset class to look at for 2018. Not only because it trades at the lowest level ever against stock prices, but also because it has historically been a very effective "reflation play". While Gold can be an attractive diversifier during periods of "hyper-inflation", industrial metals – and in particular Copper can be very effective at this stage of the cycle.

Copper by End-Use Sector

Copper is a major ingredient in big-ticket consumer goods like autos, appliances, electronics, and new homes.

Simultaneously, copper is also used as a key component in Electric Vehicles, Electric Vehicles charging stations, as well as renewable energy infrastructures.



Copper as an Inflation Hedge?

Copper plays an important role in the economy. Every year, a vast amount of copper is indeed used by the global economy to manufacture a wide variety of goods. Copper is a major ingredient in big-ticket consumer goods like autos, appliances, electronics, and new homes. Simultaneously, copper is also gobbled up for many industrial uses including telecommunications, utilities, construction, and industrial machinery.

When the economy is doing well and new things are being made, demand soars for the red metal and the price of copper is driven higher. Because of this historic relationship, analysts around the world watch the price of copper closely. Copper's long history of predicting economic movements has famously earned it a nickname as "Dr. Copper" or "the metal with a Ph.D. in economics".

Treasury Market inflation expectation (left hand chart) versus Copper price per pound (right hand chart)

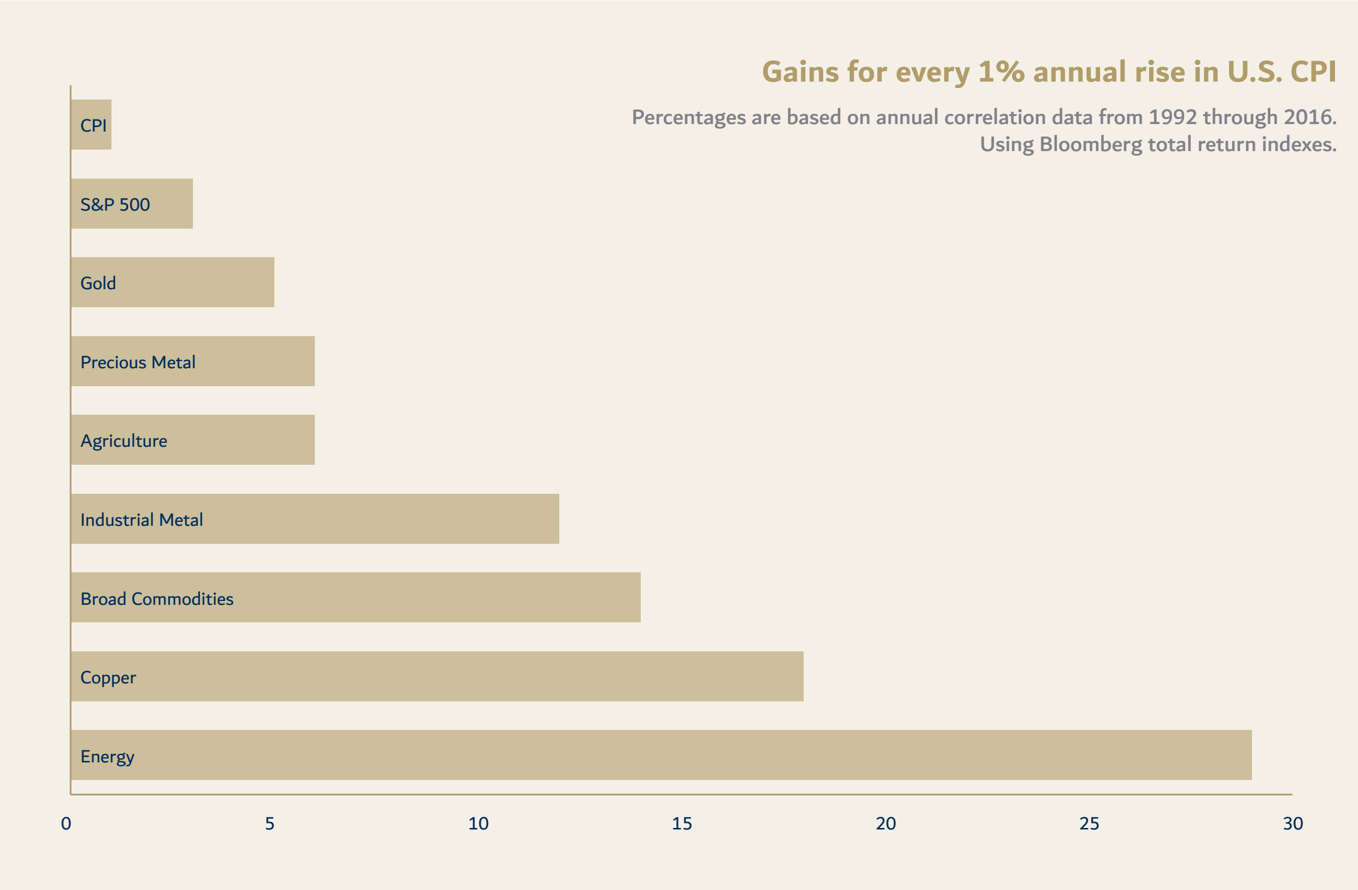
Source: US Treasury Dept.

But this link as an economic gauge has other important implications, especially for investors looking to build a robust diversified portfolio.

Given the link of copper with economic trends, Copper can be used as way to shield a global portfolio from inflation. Rising prices come from an overheating economy with strong consumer spending – the same factor that has an influence on copper prices. As a result of this connection, for every 1% annual increase in consumer prices since 1992, copper's price jumped almost 18%.

In an analysis by Bloomberg Intelligence, copper outperformed every major asset class aside from energy as an inflation hedge – and during periods of rising consumer prices, copper had triple the 5.2% gain earned by gold (see chart below).

Copper as an inflation hedge (versus other asset classes)



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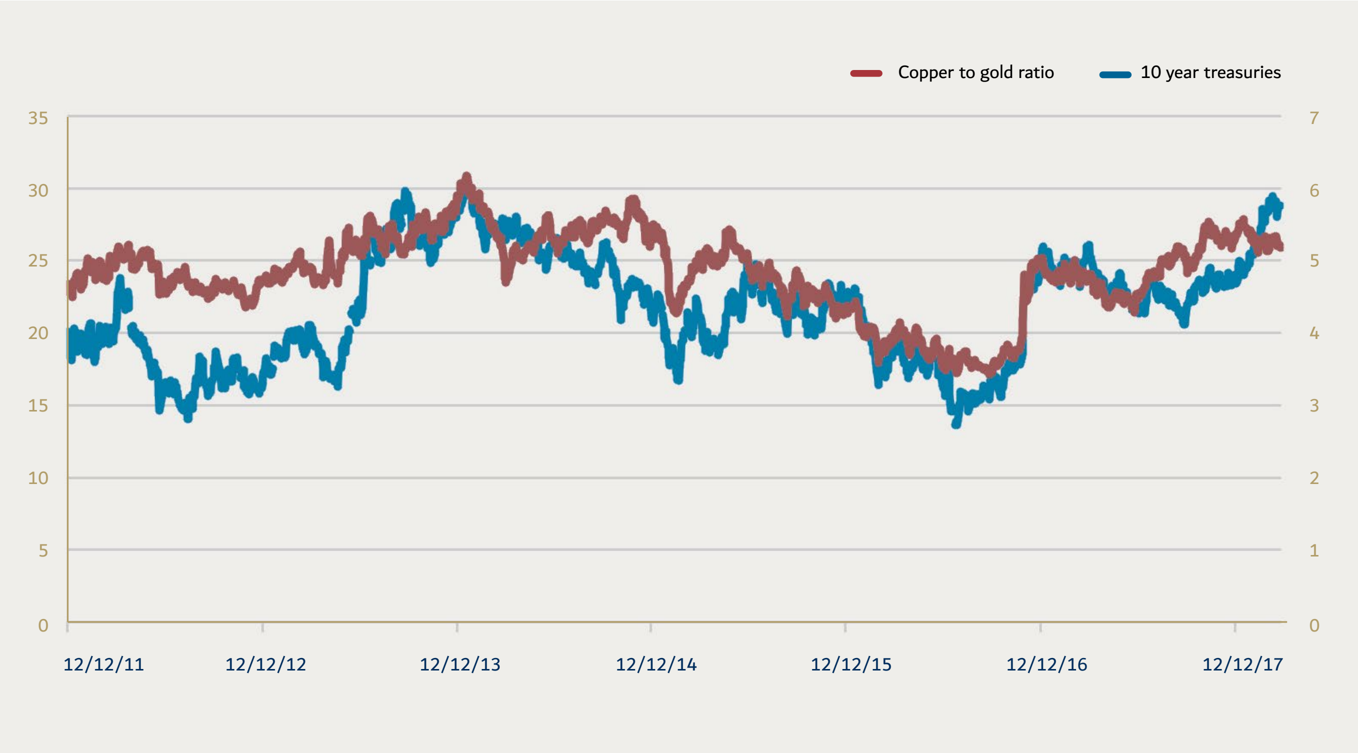
Copper as an inflation hedge



For every 1% annual increase in consumer prices since 1992, copper's price jumped almost 18%

Conclusion

As mentioned previously, we do not forecast a dramatic acceleration of inflation in the short to medium-term. That being said, we might be in the midst of a paradigm shift where the global economy is moving from a low inflation regime to a prolonged period of reflation. Such a regime shift requires a change in the way global portfolios are built. While long duration US Treasuries worked as an effective macro hedge over the last 20 years, this might not be the case anymore as equity prices and government bond prices could start to correlate positively, as observed over the last few weeks. In this context, different types of hedges should be used in a diversified portfolio and commodities could be one of them. As shown on the chart above, copper could prove to be an even more effective hedge than Gold. But given the high volatility of copper, we would advise investors to limit the size of the exposure. On a separate note, some copper stocks look very interesting as stand-alone investments. We are obviously available to discuss these ideas with our clients.

Oil: looking beyond US Shale

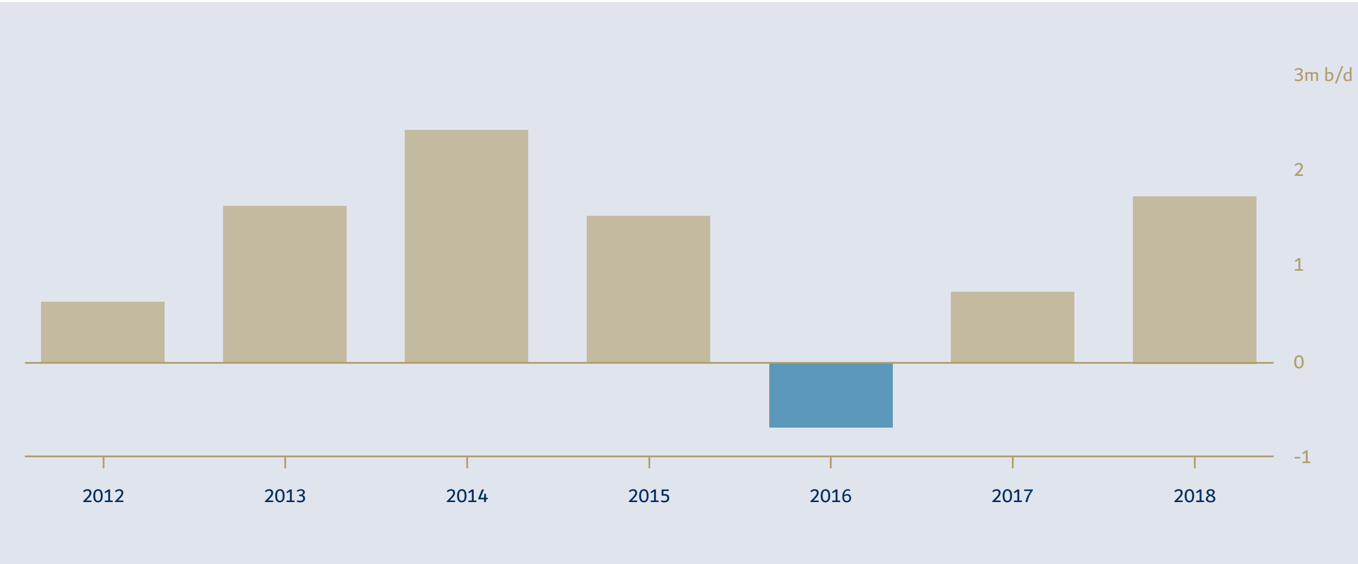
Similarly to most risk assets, WTI and Brent Oil have been going through a phase of consolation over the last few weeks as oil price is down roughly 10% from January highs.

Lingering concerns over rising production in the U.S have for sure been weighing on sentiment. Earlier this year, an IEA report projected that US shale output is poised for "explosive" growth in 2018 as the strong WTI oil rebound is likely to unleash pent up US output, potentially leading to a sharp oversupply of oil.

As Bloomberg noted, the IEA's forecast supports OPEC's own projections: the cartel also expects US production to ramp up in 2018 as shale producers - much more lean, efficient and significantly de-levered after the 2015/2016 "episode" - unleash output as oil price continues to rise well above the generally accepted shale breakeven in the low $50s. In early March, US oil production rose to an all-time high of 10.28 million barrels per day, keeping it above Saudi Arabia's output levels and within reach of Russia, the worlds' largest crude producer.

The US rig count should thus climb further in response to higher crude prices and, as highlighted in the IEA report, non-OPEC oil output growth in 2018 might very well be comparable with the best years of US shale boom (See chart below).

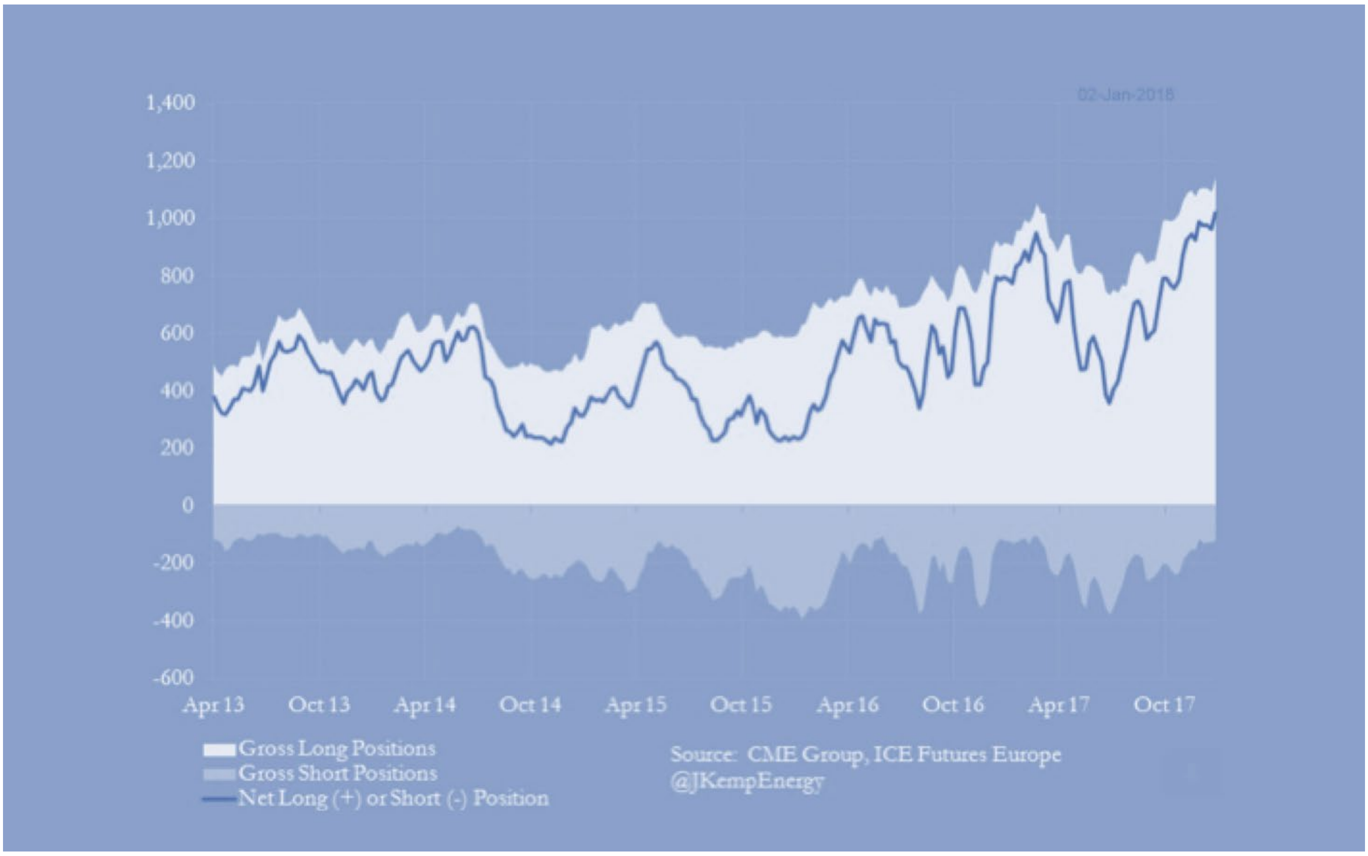
Non-OPEC output growth in 2018 is comparable with the best years of US shale boom



In early March, US oil production rose to an all-time high of 10.28 million barrels per day, keeping it above Saudi Arabia's output levels

That being said, we believe that recent oil price weakness is also technically driven as speculators are reducing their net long positions from record high levels. Indeed, as we highlighted several times in our weekly technical letter, hedge funds and speculative money managers entered the year with record gross and net long crude oil futures and options contracts (see chart below). With oil prices momentum reversing, they have been aggressively cutting their bets.

Money managers' long and short positions in the 3 main crude oil futures and options



From our point of view, we believe that oil is in a temporary soft patch and that it will soon firm again as not much seems to indicate fundamental changes in the oil market yet.

Indeed, we do believe that the rise in US output over recent weeks is overshadowing some strong positive factors. Below, we highlight eight reasons why oil prices should remain firm in the short to medium-term.

Reason #1: Strong global demand

The strength of demand growth has been the little-told story of the oil price recovery with consumption expanding by almost 5 million barrels a day between the start of 2015 and the end of 2017, compared with annual growth of well below 1 million barrels a day when oil was above $100 a barrel.

While part of this pick-up in growth can be explained by the appeal of lower prices, the recovery of the global economy is also a major factor, as most forecasters believe the world is now enjoying the strongest period of expansion since the financial crisis. As a reminder, the IMF sees global GDP rising 3.6 per cent this year.

The level of China's strategic stockpiling, which consultancy Energy Aspects estimates accounted for 150m barrels of crude over 2017, will also be closely watched, though official numbers are opaque. Energy Aspects said another 130m barrels could be placed in Chinese strategic storage in 2018. In January, China crude imports rose to record levels (+20% year on year). China now accounts for 12% of global demand.

Reason #2: OPEC and Russia seem strongly committed to the Output cut deal

The alliance between OPEC, Russia and other large producers to remove 1.8m barrels a day from the market since January 2017 has had the biggest impact on draining bloated oil inventories. In late November, they agreed to extend the deal through 2018, though it will be reviewed at the group's next meeting in June.

Meanwhile, the IEF (International Energy Forum) hosted the IEA-IEF-OPEC Symposium in Riyadh on the 14th February, bringing together producers, consumers and investors to discuss market developments.

It is interesting to note that Saudi and Russian Energy Ministers were present for the first time at this meeting together to emphasize partnership and commitment of OPEC and Non-OPEC towards the deal. Observers present at this meeting highlighted that OPEC and Non-OPEC members appear to have clearly realized the gain in supporting the deal with strong compliance resulting in higher oil prices and have a comparison to make with the previous couple of years when oil prices dropped to sub 30 in the fight for market share.

The two countries are so deeply interlocked in various partnerships that any threat to the current OPEC-NOPEC deal from the two of them seem to be limited. The feedback from many participants was that there is a stronger commitment towards the deal now than ever before.

Reason #3: Geopolitical risks

The IEA has repeatedly warned that while U.S. production is creating over-supply in the short run, U.S. shale output cannot meet future demand by itself. By the mid-2020s, especially because there are questions about the longevity of U.S. shale, there could be a much greater reliance on the Middle East, just as there was in the past.

However, according to the Oxford Institute for Energy Studies (OIES), the deteriorating geopolitical landscape in the Middle East could leave longstanding scars on the region's energy sector.

As we know very well, geopolitical tensions remain in the Middle East and North Africa. In places like Libya, Yemen and Syria, there is an absolute lack of legitimacy in government. And the presence of non-state actors such as Hezbollah, the Houthis, etc. make it tricky for oil companies and oilfield services to make investments.

At this stage, the oil market goes does not focus on these geopolitical problems as the glut of U.S. shale is grabbing most attention. Moreover, while there are plenty of sources of conflict and no shortage of potential threats, actual oil production outages have remained minimal. In fact, Iran ramped up production after the removal of international sanctions, while Libya, and Nigeria restored quite a bit of output after serious outages.

Nevertheless, geopolitical issues can one day create some future supply problems, as argued by OIES. For instance, geopolitical tension today is preventing the necessary investments in new production capacity. For example, while Iran was able to restore huge volumes of upstream production after the lifting of sanctions, the Trump administration could deter investment in oil and gas production capacity in Iran. For instance, the French oil company Total has suggested it might hesitate to invest in Iran if U.S. sanctions returned.

Meanwhile, tension elsewhere has also inhibited investment in production capacity. The Kurdish Regional Government is trying to attract upstream investment, but the conflict with the central government in Baghdad will prevent the region from scaling up output. OIES also cites the case of Libya, where unrest is not only leading to the occasional outage today, but it essentially prevents the country from realizing its full potential.

Looking outside MENA, Venezuela, another OPEC member, has seen its output fall to the lowest in almost 30 years due to an escalating economic crisis, with some analysts seeing its remaining 1.9m barrels a day of production as the biggest potential supply risk in 2018.

While this may not seem like a pressing issue today, geopolitical instability becomes increasingly problematic as the oil market tightens. Already, the cushion of crude inventories has been significantly reduced. Spare capacity is already thin, sitting at about 2 million barrels per day, which is at the low end historically. But spare capacity will shrink further once OPEC unwinds the current production cuts.

Reason #4: Large US oil producers likely to favor shareholder returns over capex

While IEA and OPEC are pointing towards more US production coming to the market, it is interesting to note that some key US oil producers signaled in their Q4 results that they will focus on shareholder returns rather than in capex expansion this year.

For instance, during the 4Q'17 earnings call, Anadarko emphasized that it would use its increased cash flows to enhance its shareholder value in the form of dividends and share buybacks, rather than chasing aggressive production growth. This could be good news in terms of capping future supply coming from the US.

Reason #5: Weak dollar

Typically, there is an inverse relationship between the value of the dollar and commodity prices. When the dollar strengthens against other major currencies, the prices of commodities tend to drop – and the reverse if the dollar weakens. This is a general rule but it holds true more often than not over time.

The primary reason for this inverse relationship is that the dollar is the benchmark pricing mechanism for most commodities because the U.S. currency is the reserve currency of the world and the money of exchange when it comes to international trade for raw materials. When the value of the dollar drops, non-USD based countries have more buying power as it takes less of their currencies to purchase a dollar.

For various reasons, the dollar has been surprisingly weak over the last few months. While the greenback looks oversold in the short-run, the US administration fiscal policy and infrastructure spending plans should translate into larger twin deficits going forward which could mean more weakness for the dollar.

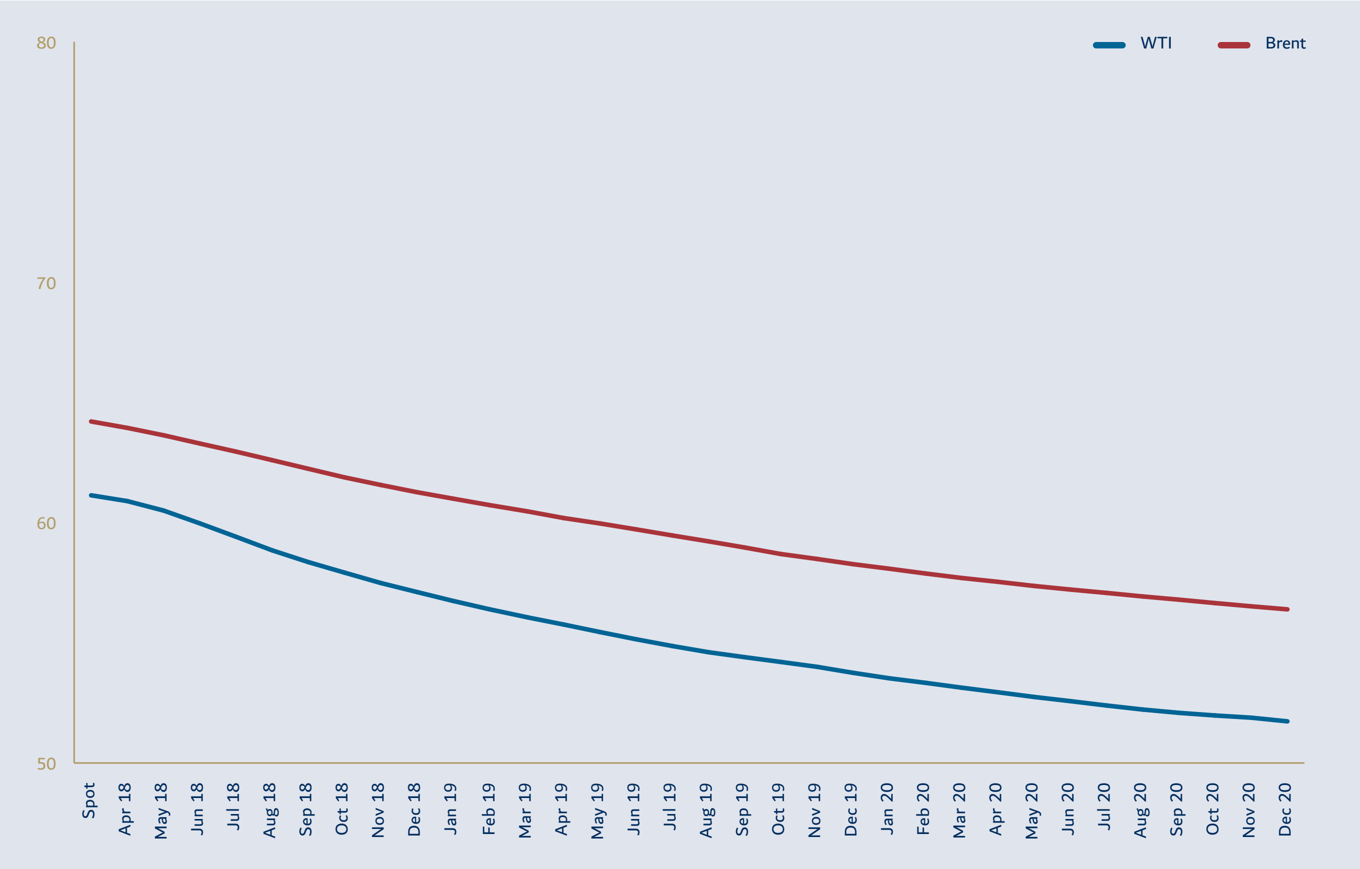
Reason #6: Curve in backwardation

As mentioned in the introduction, Hedge funds have been riding the oil rally, accumulating a record bullish position equivalent to more than 1 billion barrels across Brent and US benchmark West Texas Intermediate in the belief prices will keep marching higher. They have probably been taking some profits recently and pressuring the market.

Still, there are good reasons to suspect they will keep if not accumulate their net long positions given the current shape of the curve.

Since the middle of last year, the market has moved into backwardation — which means that spot prices trade higher than contracts for delivery in later months (see chart below). Such a shape of the curve is an indication of a tight market and makes holding long financial bets in oil more attractive as investors can earn a positive yield each month by rolling positions forward (i.e the "roll yield").

Both WTI and Brent Curve are in backwardation (source: Bloomberg)



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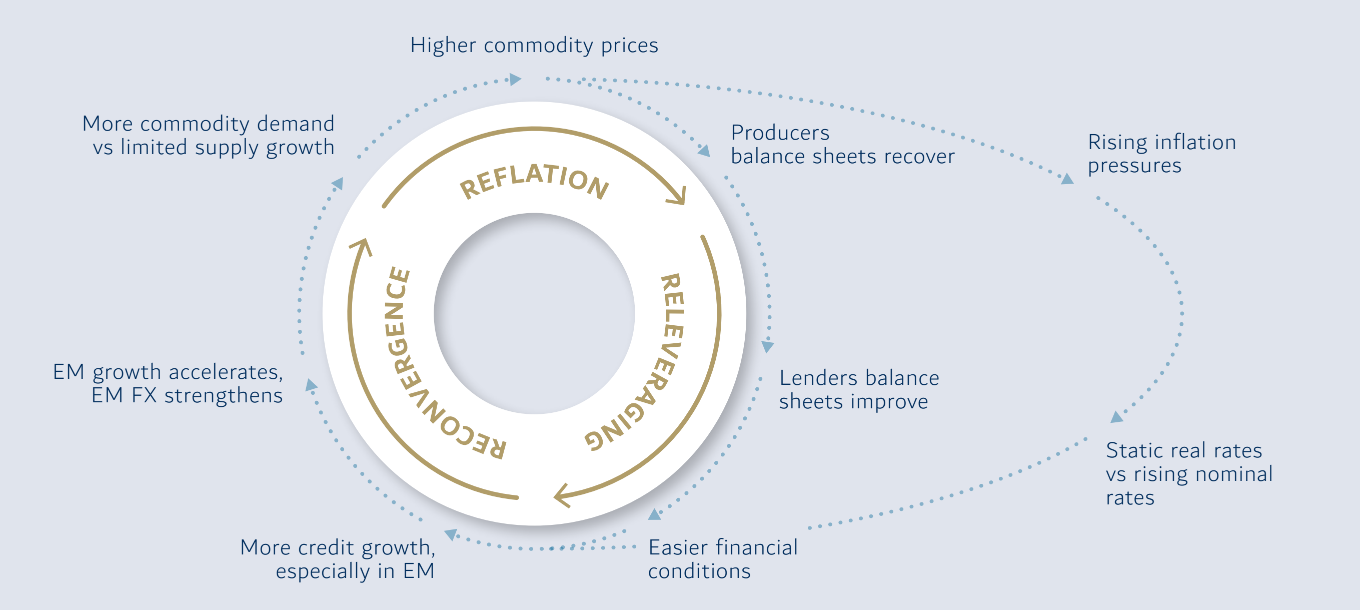
Reason #7: A positive feedback loop for commodities

As already highlighted in previous editions of Perspectives (see January 2018), Commodities have never been that cheap versus S&P 500. As asset allocators rebalance their portfolio, this might be an interesting relative value call to consider, especially if the reflation theme plays out as expected.

Last month, Goldman Sachs published an interesting view on commodities. To their opinion, a self-reinforcing loop of reflation, re-leveraging and re-convergence (the 3R's) is reinforcing their overweight commodity outlook (see figure below). Basically, the rise of commodity prices due to the current reflationary cycle will not only spur inflationary pressures but also strengthen the balance sheets of commodity producers as well as the financial strength of their lenders. These two forces combined create easier financial conditions which in turn will spur a re-leveraging cycle. Thanks to increased credit growth, especially in emerging markets, growth in EM is likely to accelerate and EM forex should strengthen. This "re-convergence" is likely to push commodity demand higher at a time supply growth is limited, hence driving commodity prices even higher, and so on. Should this happens, expect oil prices to rise as well.

The '3Rs" should push commodity prices higher (source: Goldman Sachs)



Reason #8: Seasonality

Oil prices used to have a predictable seasonal swing. They spiked in the spring, as oil traders anticipates high demand for summer vacation driving. Once demand has peaked, prices dropped in the fall and winter. We will thus soon enter a favorable season for oil prices – if history is any guide.

Conclusion:

We do believe that recent oil prices weakness was mainly driven by technical factors. The markets are already in a balanced state due to stronger-than-anticipated demand growth continuing into 2018 and OPEC-NOPEC's strong compliances leading to a rapid decline in oil inventories. We expect this tightness to be further exacerbated by OPEC's reactive nature to such a scenario rather than proactively revising the quotas on a dynamic basis. 2018 and 2019 will have quarters of tightness and surplus. In the tight quarters, large scale disruptions could push prices up significantly. On a short-term basis, with some of over-optimism having been washed out and as seasonality becomes more favorable, we expect oil prices to be skewed to the upside and come back to the highs observed at the start of 2018.

A "Deep Dive" into Saudi ARAMCO IPO Why, How Much, Where and When?

In the last few months, there has been a flurry of articles about the Initial Public Offering (IPO) of Saudi Aramco. As the Financial Times has recently noted, 'this is no ordinary IPO … the listing is different to every other in terms of scale, the nature of the offering, the uncertainties around it, the timeline, the process. Nothing about it is comparable'.

Below, we review some key facts and figures about Aramco. We then look at the drivers behind this giant IPO, as many wonder if it is an exit strategy from the fossil fuel sector by Saudi or the first step in rebalancing their economy. While Prince Mohammed Bin Salman ("MBS") expects the state oil company to be valued at more than $2 trillion, many analysts claim that the numbers do not add up. We thus look at some estimates for Aramco reserves and expected earnings in order to come up with a valuation range. In the later section, we open the debate on where and when this IPO might take place. To finish with, we look at historical precedents and what could be the impact of this mega IPO on our regional benchmarks.

Who is Aramco?

Founded in 1933 and headquartered in Dhahran, Saudi Aramco is by far the largest oil exploring and producing companies in the world, supplying nearly one-tenth of global oil and generating a billion dollar of revenues per day. With oil reserves of 261 billion of barrels, it controls more than one-fifth of global petroleum reserves, it is s nearly as big as Venezuela's oil reserves as a whole, bigger than Canada's oil reserves, and are over ten times more than that of Exxon Mobil, the world's largest publicly listed oil company with a market capitalization of US$362 bn.

Aramco also boasts nearly 294 trillion standard cubic feet (scf) of natural gas reserves. Reports suggest that Aramco is the world's second largest producer of crude oil (behind Venezuela) with a production of 10.2 million barrels per day (versus a capacity of 12.5 million barrels per day).

According to industry sources, the cost of production for Aramco is around $10 per barrel, which is a significant competitive advantage to the US$25 to US$80 per barrel cost for US-based companies.

Aramco is obviously a huge contributor to Saudi Economy. The state-owned oil producer alone contributes to 45% of Saudi Arabia's GDP, 90% of the country's export revenues, and almost 80% of budget revenues. Aramco plans to invest $334 billion over the next 10 years to sustain oil production: 42% will be on drilling, 31% on facilities and 11% on infrastructure. They plan to tap debt markets for $10 billion to finance this program.

Aramco also has significant influence on how the official selling price (OSP) of crude oil is determined – calculated by adding a differential to a specific crude oil benchmark price depending on the location of a customer and quality of crude oil being considered.

Saudi Aramco is not only an upstream giant but it also owns some downstream assets such as the Sadara Chemical Company - a $20 billion JV with Dow Chemical - and the largest chemical plant ever built in one phase. Over the last years, Saudi Aramco has been increasing its investments in chemicals. The Sadara uses oil and gas to produce a range of specialty chemicals found in everything from cosmetic to car parts. This plant exemplifies Aramco (and indirectly the Saudi government) drive to develop higher value industries such as petrochemicals, which can be built on rather than replace the kingdom's natural resources. Amin Nasser, Aramco' CEO, portrayed the Sadara plant as a demonstration that Saudi Aramco can become an ally of economic diversification instead of an obstacle.

A global refining expansion is another long-term play for Aramco. The state owned company already operates international and domestic J-Vs in refining such as Motiva (partner: Shell) or Saudi Aramco Total Refining and Petrochemical (partner: Total). By acquiring stakes in foreign refineries the company is banking on locking in buyers for the Kingdom's crude in fast-growing markets such as China, India and Indonesia. CEO Amin Nasser highlighted that Aramco exploration program is one of the biggest in the world and that adding more gas, more chemicals is a demonstration of their actions.

The expansion into downstream assets by Aramco shows that Saudi leaders understand that until now, they have been losing tremendous value by exporting commodities and importing finished products in which all the value is contained. The focus on petrochemicals shows how the "new economy" promoted by MBS remains linked to the country's oil. In some ways, exploiting and preserving their main resource – at least over the next 20 years – and use that income to develop entirely new sectors seem indeed like a wise strategy.

Aramco is the largest company in Saudi but also a benchmark for the Kingdom. Indeed, not only the state-owned company employs a huge number of people (around 61,000 employees by last count), but it is also seen by many as a model for the more dynamic and open society which MBS is trying to promote. Founded in the early 1930s as a partnership with Standard Oil of the US, the company prides itself on hiring the best and brightest young Saudis – a symbol of meritocracy in a tribal culture. It strives for the highest standards of operational excellence, has a multinational workforce and has accounting and government structures similar to the biggest international oil majors, particularly ExxonMobil. In the Dhahran compound, men and women work side by side.

In early 2017, Saudi Aramco announced its intention to IPO the company for the first time ever. The announcement came as a surprise to many. Indeed, being the largest oil company in the world with presumably the largest reserves and lowest production costs, the reasons behind the IPO continue to be of interest. In the next section, we explore the main drivers behind this IPO.

An Oil Giant

Saudi Aramco has petroleum operations that cut across the industry.

SOME OF ARAMCO'S OPERATIONS BY TYPE:

Oil Production

Upstream Assets

261

billion barrels of proved conventional oil reserves

12.5

million barrels a day production capacity

10.2

million barrels a day production

Petrochemical

Downstream Assets

Sadara Chemical Company
A $20 billion 50/50 joint venture between Aramco and Dow Chemical. Located in Jubail. World's largest chemical plant ever built in one phase. IPO expected in 2016.

Source: the company
The Wall Street Journal

Refining

Downstream Assets

INTERNATIONAL JOINT VENTURES

Motiva | **Partner: Shell (U.K/Dutch)**

1.1 million barrels a day capacity

S-OIL | **South Korea**

0.67

DOMESTIC JOINT VENTURES

Saudi Aramco Total Refining and Petrochemical | **Total (France)**

0.40

Yanbu Aramco Sinopec Refining | **Sumitomo (China)**

0.40

Yanbu Aramco Sinopec Refining | **Sumitomo (China)**

0.40

DOMESTIC WHOLLY OWNED

Ras Tanura

0.55

Jizan

0.40

Proceeds from the Aramco sale could reach around $100 billion

If Aramco achieves the $2 trillion valuation, it would become the World's biggest company by far – three times the size of Apple Inc.

Why an IPO?

So why would the Gulf country go public with one of its best run state firms that also gives it the power to become the swing producer in the global oil market?

At an early stage, there were suggestions that Saudi Aramco could choose a more cautious route of 'listing of a bundle' of refining subsidiaries and other downstream assets. But over time, the signals became stronger in favor of an IPO of a minority stake (initially 5 per cent) in the entire company including upstream.

The main drivers behind the IPO have also evolved. In the early stages, the objective of the IPO was focused on the company to showcase Saudi Aramco and make it part of the global capital markets, unleash the company's capabilities, allow it to expand internationally and to remove this notion that Saudi Aramco is not transparent. That aim is similar to the objectives in international listing of other countries' state owned enterprises and other corporations.

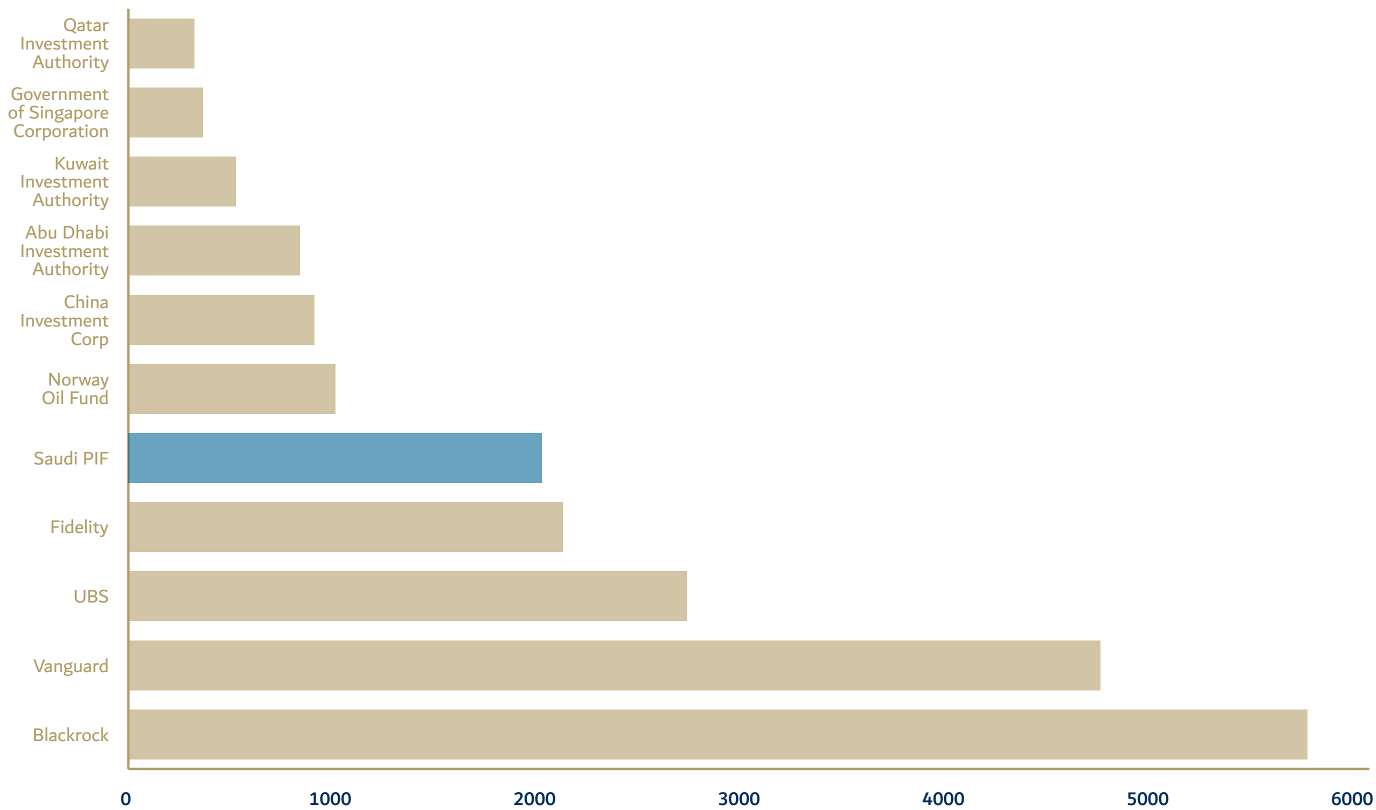
According to a blog post written by Yasser Al Saleh, senior research fellow at INSEAD Innovation and Policy Initiative, this IPO also convey a broader message to the economy. Listing Aramco is not about raising money as such; it is more a bold political message that no sector is immune from privatization.

However, while the aims mentioned above might be relevant, we do see them as secondary ones. Indeed, we do believe that privatizing Aramco is first and foremost a key milestone for the economic shakeup announced by MBS in order to wean the local economy off petrodollars and to better diversify the national income. The need to reform the economy gained urgency when Brent plunged from $100 a barrel on average from 2010 through 2014 to less than half that amount.

Proceeds from the Aramco sale — which analysts estimate could reach around $100 billion, more on this in the next section — will be diverted to a public investment fund (PIF) that would act as a cover for post-oil days for Saudi Arabia. Indeed, the Prince has floated the idea of forming a US$2 trillion mega fund, likely to be funded by the Aramco IPO proceeds. The aim of the fund is to achieve a level of nearly 50% of its total investments in foreign assets and invest into new industries ranging from technology to mining, thereby shifting the economy's dependency away from oil. This is a key aspect of the Vision 2030 plan.

How would the Saudi Public Investment Fund stack up?

Size in USD billion



From an objective point of view, it does not seem that the Sovereign Wealth Fund (SWF) idea is much about "real" economic diversification (which is often associated with expanding the economic base and job creation). We do think that the fund is mainly about income diversification and boosting the financial resources available to the kingdom. As the experience of neighboring countries has shown, sovereign wealth funds predominantly diversify their assets by investing in foreign markets rather than in diversification of the domestic economy into employment creating sectors.

The recent deal between Soft Bank and the PIF to launch one of the largest tech investment funds in the world could be an indication that most of the investments will be allocated towards technology sectors outside the Kingdom, with limited impact on the real economic structure of the economy. According to a recent report, the PIF has already channeled about $50 billion into investments abroad, the bulk of it into technology with some warning that there is 'a risk that PIF are chasing the bright lights', and instead 'they need to pay attention to valuations'.

Another key objective of many SWFs in the region is to earn the government a higher rate of return than on foreign exchange reserves since their investment mandate emphasizes high risk-return profile. From our point of view, the rate of return on foreign exchange reserves should not be the benchmark for comparison. Indeed, it would be legitimate to consider financing Vision 2030 from borrowing on global debt markets.

Last year, Saudi Arabia managed to raise $17.5 billion in the biggest ever bond sale from an emerging market (the offer was oversubscribed) with very attractive rates with, for instance the 10-year note yielding at a spread of 165 basis points above the US benchmark. It would thus be legitimate to compare the discount rate used for the Aramco IPO with a risk-adjusted cost of borrowing when it comes to finance Vision 2030.

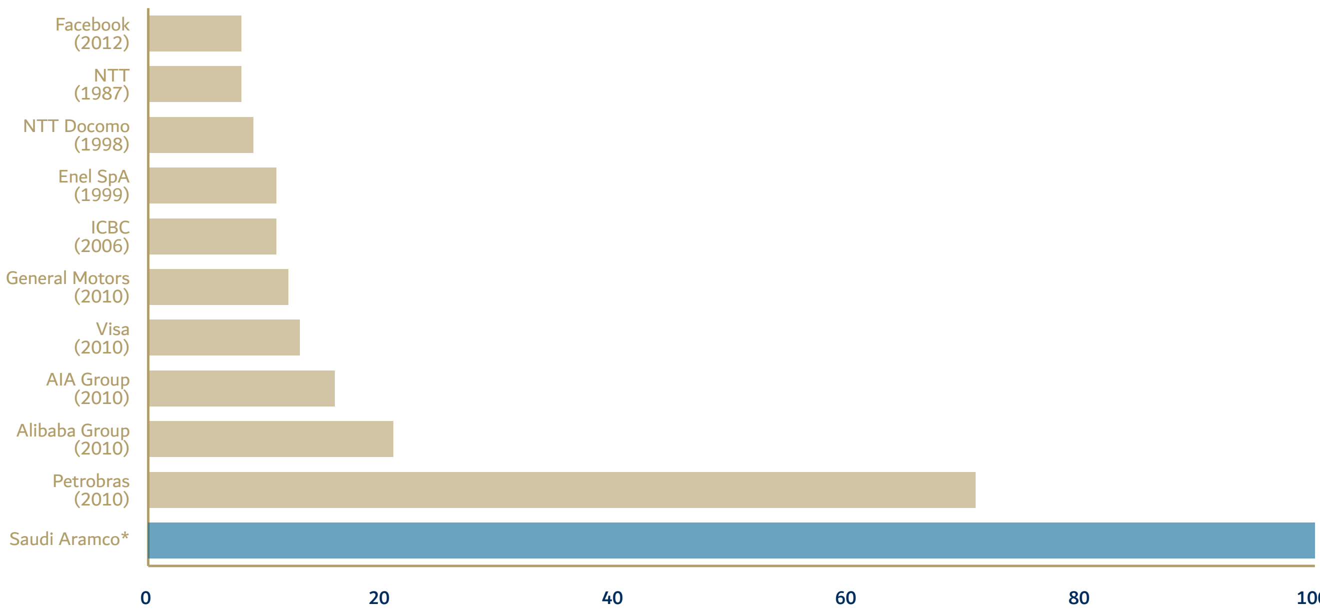
Another important criterion is whether the PIF investments can achieve better social returns through accelerating the diversification of the Saudi economy. Only time will tell. For instance, the PIF has recently invested $3.5 billion in car-booking app Uber, which according to the Financial Times reflects 'two core mandates of its sovereign wealth fund: generate growth and aid sectors that can help the oil-dependent economy to diversify'. Whether such an investment will succeed in meeting these two objectives should be straightforward to assess.

For how much?

If Aramco achieves the valuation targeted by the Crown Prince ($2 trillion), it would become the World's biggest company by far – about three times the size of Apple Inc. and six times larger than Exxon Mobil Corp.

And a 5 percent sale of a $2 trillion company would bring in about $100 billion, dwarfing the $70 billion IPO by Petrobras in 2010 and the $25 billion snared by Chinese Internet retailer Alibaba in 2014 (see chart below).

The world's biggest IPOs (By float Market Cap in USD billion)



There have been much skepticism about the $2 trillion valuation initially put forward by MBS. In order to secure the highest valuation as possible, Aramco will have to reassure investors on two key pieces of information: 1) the size of its oil and gas reserves and; 2) its current and future financial performance.

Aramco's size of its oil and gas reserves

Based on Aramco's oil reserves of 261 billion barrels and a valuation of $7 to $8 per barrel in line with recent industry acquisitions – such as Total's purchase of Maersk's oil assets – Aramco warrants close to the $2 trillion valuation. Presumably, the country's 298 trillion cubic feet of natural gas, equivalent to 49 billion barrels of oil, will also be included.

However, there has been much confusion as to whether the underground reserves will continue to be owned by the State following the IPO. This debate is rather redundant, as what matters is the type of agreement between the State and the operator, which, in the case of Saudi Arabia, is based on a concession agreement. Like any other concession, the holder is given the right to exploit and monetize the underground reserves in return for payment of taxes and royalties to the government.

Aramco's financial performance

No matter how much oil and gas Aramco oversees, the earnings rather than the assets will matter more to the market. As recently put by Total's CEO, the value of an oil company is 'not a multiplicator of the reserves of the company'. Instead, the company should be valued on the basis of models that discount future cash flows, which depend primarily not only on the quantity of oil produced but also on the profit per barrel.

The profit per barrel in turn is highly sensitive to the level of taxes and royalties that the government imposes on Saudi Aramco; if the taxes and royalties are high, then the valuation will be low and vice versa. Based on the old system of a royalty of 20% and taxes of 85%, many have shown that the valuation will be far less than the $2 trillion number put forward by MBS.

For instance, based on a price of $70 per barrel, production of 10 million barrel per day, a production cost of $8 per barrel, 20% royalty payment, an 85% tax rate, and a 70-year production period, Boslego (2017) calculates the net present value of the company only at $251 billion at a 10% discount rate. To achieve a higher valuation, the government has recently cut the tax rate to 50%. Bloomberg reports that Wood Mackenzie's rough valuation of Aramco's core business is not far from this number at about $400 billion.

Since valuation depends on the tax rate applied to future production it will be affected by the Saudi Arabia's public finances, which are already strained by lower international oil prices over the recent years. But taxes and royalties are not the only contributions to the Kingdom's finances from Saudi Aramco. The reduction in tax rate designed to support the IPO valuation could be partially offset by, for example, Saudi calling for maximum dividend payments on a more frequent basis. While this is good news for investors seeking large dividends, it undermines Saudi Aramco's ability to retain funds inside the company and would disrupt the government's existing stable cash flow streams based on royalties and taxes in favor of uncertain streams of income.

As the Kingdom changes from an era of buoyant revenues to one where social and developmental expenditure is subject to tight budget constraints, a tax rate of 50 per cent or lower may not be sustainable. Therefore, the government by reducing the tax to lower levels in support of the IPO may not necessarily achieve the desired higher valuation, as investors, recognizing the unsustainability of a lower tax regime, will reduce the shares' valuation by applying a higher discount rate to the stream of cash flows.

The government could enter into legally binding contracts to fix tax/royalty rates to show its firm commitment to low taxation, but these commitments are not credible in the long-term, will expose the company (and the country) to unnecessary legal risks, and most importantly will undermine the sovereignty of the State by giving up on a fundamental power to adjust taxes.

As highlighted in a report by the Oxford institute for Energy studies, this discussion highlights a key fact: the IPO of Saudi Aramco cannot be isolated from transformations in the rest of the economy and there are key trade-offs that the Saudi decision makers can't ignore. For instance, reducing the tax and royalty rates on Saudi Aramco would increase the company's valuation, but would squeeze substantially government finances, which still rely heavily on oil revenues. Therefore, the economy has to adjust to lower oil revenues, by boosting non-oil revenues, cutting current and capital spending, borrowing from local and international markets, and above all diversify the economic base, which according to the current leadership can only be achieved through a successful IPO of Saudi Aramco. This reflects clear circularity in approaching the fiscal sustainability issue.

An EV/EBITDA valuation approach

Coming back to Aramco valuation, it could be interesting to use EV/EBITDA (enterprise value versus core earnings), a simple and globally accepted ratio which can help us to compare Aramco with some peers in the industry.

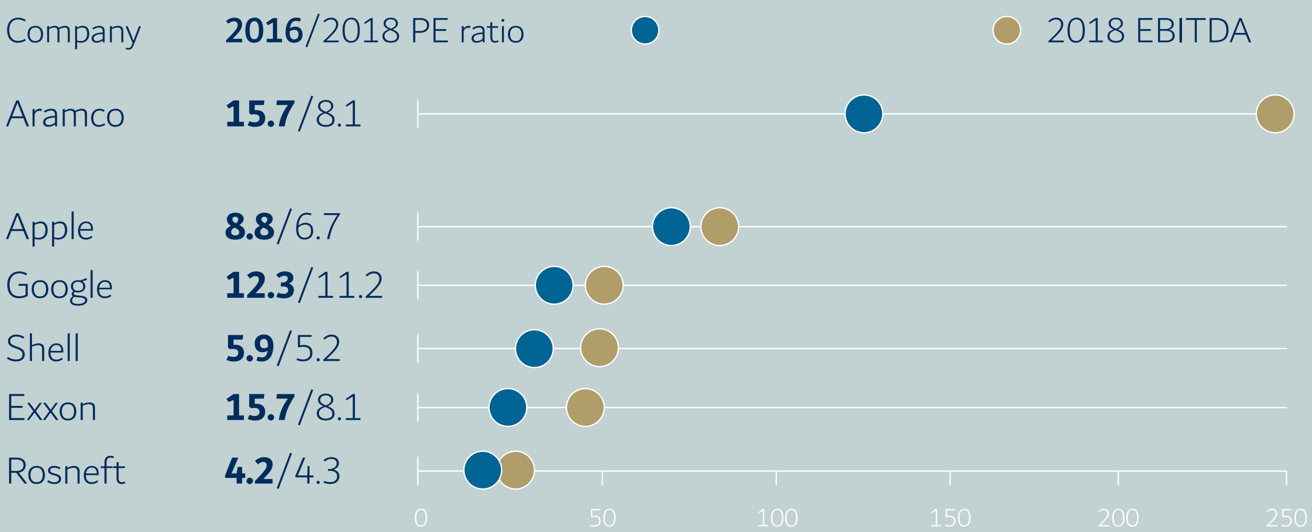
By looking at peers EV/EBITDA, it looks like the Saudi firm needs to report EBITDA in the region of $130 billion to achieve a $2 trillion valuation. Such an EBITDA figure would be unprecedented, as no firm in any industry has reported earnings before interest, tax, depreciation and amortization (EBITDA) above $100 billion.

By comparison, Apple, the technology giant and the world's most valuable listed firm that is worth around $900 billion, reported EBITDA of $60 billion in 2016. Exxon Mobil, the world's largest listed energy firm with a market capitalization of $320 billion, reported EBITDA of $23 billion in 2016, according to Thomson Reuters Eikon data. In 2012, it reported EBITDA of $65 billion – but that was when oil traded well above $100 a barrel. Benchmark Brent crude is now around $65.

In 2016, Exxon traded at EV/EBITDA of more than 15 times, which is high by energy industry standards. If Aramco matched that same high ratio, its core earnings would need to be around $130 billion to achieve its target valuation (see chart below).

Saudi Arabia's Aramco

Reuters projections of possible Aramco earnings based on Aramco's aspired $2 trillion valuation and a price-to-earnings ratio of Aramco's closest rival, U.S. Exxon Mobil



Sources: Reuters analysis of company data. 2018 values are forecasts.

For sure, with its oil output of about 10 million barrels per day (bpd) and some of the world's cheapest crude recovery rates, alongside its global refinery network that adds further value, Aramco could prove hugely profitable.

Although Aramco has never published results, conclusions about its earnings can be drawn from Saudi Arabia's accounts. Based on the Saudi current-account balance, Aramco had revenues of $160 billion in 2016 from just oil and refined products exports when the average price of oil was $43 a barrel. Should the price of oil stabilizes around $70 per barrel, it is not impossible for Aramco to make a top line of $250 billion a year. Given that operational costs of Aramco are one of the lowest in the world, it is not impossible to see them reporting the bottom line or earnings on a huge scale – of $100 billion a year and above.

Valuing the stock as a high income low growth stock

Alternatively to the valuation methodologies discusses before, some might consider Aramco as a low-growth, income stock. Even though it is the most powerful member of OPEC, Saudi Arabia is restricted in being able to raise production. Thus earnings growth will have to come via oil and gas prices. If all the free cash flow goes to the dividend that would mean a high payout but not an unrealistic one for a cash cow.

On a 5% required yield, similar to the largest oil groups, Aramco looks to be worth at least $1.1 trillion. With the dividend expected to grow steadily, the valuation would rise higher.

On a 5% required yield, similar to the largest oil groups, Aramco looks to be worth at least

$1.1 trillion

Geopolitical risk premium

Financials aside, investors will also assess country risk when working out Aramco's valuation. Saudi Arabia is a key player in international oil markets; historically it has assumed a key role in shaping OPEC policy and is the only country with an official policy to hold spare capacity. Changes in oil policy, which are sovereign decisions, can have a direct impact on the company's valuation through its impact on production levels and prices. While one could assume that the government will take decisions for the benefit of the company (for instance by cutting output to increase prices), Saudi oil policy has come under criticism in recent years, reflecting the divergence of views regarding the effectiveness of Saudi oil policy in face of a structural shock.

Where is the stock expected to be listed?

Most global stock exchanges in the world would love to handle the IPO of the world's biggest oil producing company. Stock exchanges in Hong Kong, Singapore and Tokyo have all courted the Saudis, and King Salman bin Abdulaziz visited Asia early last year. China offered to buy a stake in Aramco through its sovereign investment fund and largest energy company and it was heard that Singapore made a similar offer.

While an Asian listing is an option, Aramco could also sell shares in New York or London along with the main listing in Riyadh, where the Saudi Tadawul exchange is located, Aramco's CEO Nasser told Bloomberg in January.

On the international front, it looks like 7 exchanges have been short listed: New York, Tokyo, Hong Kong, Toronto, London, Singapore and Australia. A study by Reuters Breakingviews look at the market and political factors to be considered for the IPO location. Based on how these exchanges rank on each of these factors, Reuters established two rankings: one overall ranking and one which excludes Saudi crude exports and dependence - results are shown in the table on the next page.

Ranking bourse locations based on market and political factors

Sources: Reuters BreakingViews

	New York	Tokyo	Hong Kong	Toronto	London	Singapore	Australia
Overall ranking	1	2	3	4	5	6	7
Ranking ex. Saudi crude exports & dependence	1	5	3	3	2	6	7
Market capitalisation of exchange	1	2	3	5	4	7	6
Average daily turnover last year	1	2	4	5	3	7	6
Presence of foreign companies	3	7	6	4	2	1	5
Value of oil & gas IPOs since 2010	1	7	3	2	4	6	5
Saudi crude exports to exchange nation last year	3	1	2	5	6	4	7
Dependence on Saudi crude	4	1	5	3	6	2	7

From the above, it looks like New York is the most attractive exchange for Aramco while Tokyo is a top wild-card.

If the presence of foreign enterprises in the stock exchange is the top priority, Aramco might choose Singapore. Almost 40 percent of its listed companies come from beyond its borders. That's a higher proportion than the other bourses reviewed by Breakingviews. Aramco's market value would dwarf the city-state's exchange by almost threefold, however, and is one reason Singapore ranks overall near the bottom.

Tokyo would be a good option for strengthening ties with a key customer. Japan bought more than a third of its total crude imports from the Saudis last year. The Tokyo Stock Exchange – though it has accommodated no oil and gas IPO of significance since 2010 and is the least welcoming to foreign companies – also could provide ample liquidity. That helped it place second overall in the Breakingviews rankings.

When taking out the oil ties considerations, London jumps to the second spot, followed jointly by Hong Kong and Toronto. Tokyo then would fall, and sit ahead of only Singapore and Australia. Aramco also may have a soft spot for the British capital given its board includes oil grandees Mark Moody-Stuart, former chairman of Royal Dutch Shell and Anglo American, and Andrew Gould, BG Group's former chairman. There's no obvious winning point for Hong Kong.

The best destination, by far, is the New York Stock Exchange, assuming only one of the city's exchanges gets selected. It has the largest market capitalization, the most trading volume and has led the way by a large margin on recent oil and gas listings. Even if the national climate is becoming more hostile to foreigners, the Big Apple bourse itself is notably welcoming, too. Yet a US listing has its own problems – for instance, the Saudi state has exposure to lawsuits in the US.

The Jury is thus still out.

When is the IPO expected to take place?

This is the burning question in the oil industry: when will Saudi Arabia pull the trigger on the Aramco stock market listing?

Saudi officials have given few clues about the IPO, with energy minister Khalid al-Falih and finance minister Mohammed al-Jadaan saying only that the government will proceed when "the time is right". Some Saudi sources have however said the listing on a local bourse could happen before the international listing.

Many considerations are likely to influence the IPO timing, and the final decision may rest with MBS. While some industry experts are focusing on the current level of oil prices as a trigger for the IPO, another key consideration for Saudi officials is where they see prices in one to two years' time. According to some analysts, so-called long-dated prices for one and two years ahead need ideally to move at least $10 higher - to around $70 per barrel - for the government to be happy to launch the listing.

Another important point to consider in terms of IPO timing is Saudi inclusion decision by FTSE and MSCI. It is expected that Saudi Arabia will get the approval from FTSE in March 2018, and MSCI in June 2018, for a potential inclusion in 2019 (Mar/Sep for FTSE, May/Aug for MSCI) driving roughly USD14 billion of passive inflows and up to USD30-45bn in total inflows based on a comparison with ownership in the UAE and Qatar, and other EM peers.

The expected EM inclusion in 1H18 and oil prices at USD69-70 per barrel provide a good environment / timing for an Aramco IPO to take place in 2H18, which is the timeline suggested in recent media reports. But at the time of our writing, sources from British officials said that the IPO (or at least the foreign floatation) could be delayed until next year. Saudi Aramco officials declined to comment on the timing.

Aramco listing impact on EM and regional benchmarks

The potential impact of Aramco's listing on benchmarks is a theme which is now in focus as according to a Reuters' story last month, the Shura Council's fiscal committee asked the CMA to "make sure that the stock market's liquidity does not become concentrated in the giant oil company alone" and "to study the impact of listing Saudi Aramco on the local bourse".

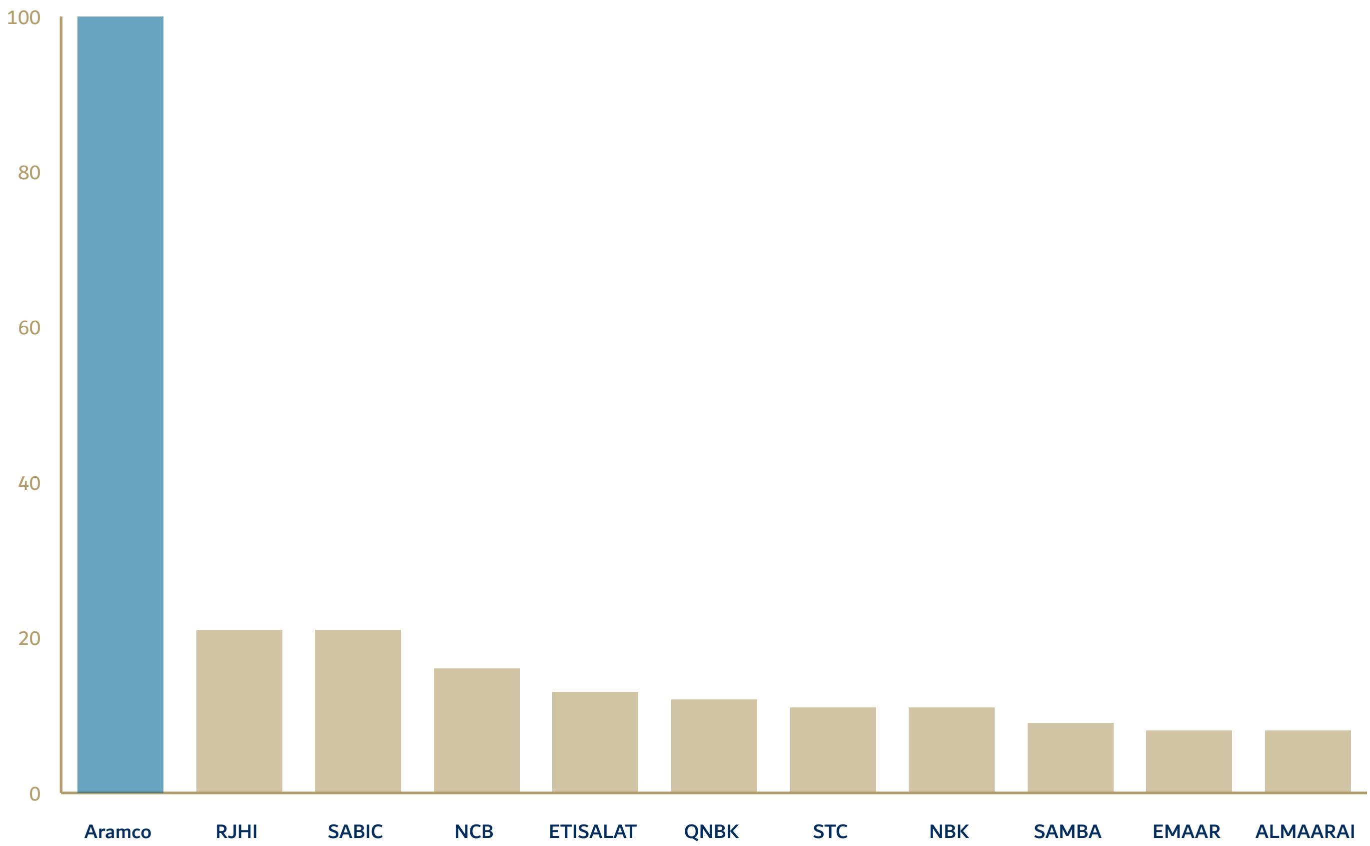
The size of the Aramco listing raises some key questions:
i) how will local and regional investors fund their participation in the Aramco IPO;
ii) what impact will it have on local and regional markets?; and
iii) will we see a capped Tadawul index (Tadawul excl. Aramco)?

Based on a EFG Hermes report, it is estimated that every USD10 billion in float market cap should lead to around 20 basis points additional weight in Emerging Markets (we expect 2.2% of MSCI EM at current prices for Saudi excl. Aramco), and around USD1.1 billion of inflows from MSCI and FTSE trackers.

Aramco will likely be the largest name in MENA by float market cap, the second largest in EMEA and one of the Top 10 names in Emerging Markets. Assuming a USD50-100bn free float, Aramco could account for 20-34% of the Tadawul Index, the largest names now are RJHI and SABIC with 12% and 9%, respectively. It would also mean that Aramco is 16-27% of MSCI Arabian Markets and 6-11% of MSCI EMEA.

The IPO is expected to be a challenge for local and regional relative mandates as index performance, once it is included, would largely depend on Aramco's performance and therefore oil prices. It is highly likely that we will see an increase in the use of custom-local and regional benchmarks that would cap Aramco (within Saudi indices) and cap Saudi & Aramco exposure (within regional indices).

Aramco could dwarf MENA / Saudi names
(By float Market Cap in USD billion)



Historical precedents

The only IPO in the oil & gas industry that possibly generated similar buzz and bore reasonable similarities was that of Petrobras' in 2010. Brazil's state-owned oil producer raised US$70 billion by selling 36 per cent of the government's stake. Brazil's oil sector, back then, contributed nearly 10 per cent of the country's GDP.

Brazil's government received $43 billion in shares in exchange for allowing Petrobras to drill for 5 billion barrels in reserves. The offer was also part of Petrobras' development targets in 2010, with capital worth $224 billion needed over five years for oil extraction from the "pre-salt layer" under approximately 4,000 m of salt which was further 2,500 m below the Atlantic Ocean.

However, five years after ambitious production targets and raising a significant amount of money, the company's performances have fallen a bit short of expectations. Not to mention, the political and corporate irregularities that started to surface. Reports of funds from construction companies being diverted for political purposes and large amounts of unaccounted expenses also impacted investor confidence.

Brazil's state-owned oil producer raised US$70 billion by selling 36 per cent of the government's stake

We take away the following from the Petrobras example:

» A big government stake meant there was always a mix of politics and business which impacted performance and ultimately Petrobras' market valuation.

» Given the size of the IPO and a subsequent weak performance meant the Brazilian Stock Exchange bore the brunt of it. At one point Petrobras accounted for nearly 10% of the country's total market capitalization. A sell-off in a counter as big as this can easily trigger a 'risk-off' trade and exacerbate the impact.

Conclusion

As discussed earlier, Aramco IPO is closely intertwined with developments in the domestic economy and the two should thus not be treated in isolation: the current economic reforms and adjustment measures will have a direct impact on the valuation of the company, the timeline and the process of the IPO, and in turn the IPO of Saudi Aramco will determine the pace of economic adjustment, the process and nature of reforms, and above all whether Vision 2030 will succeed in achieving its ultimate goal of economic diversification and creating jobs for the thousands of young Saudis entering the labour market each year.

But the IPO of Saudi Aramco reflects a more fundamental question about the future role of the Saudi energy sector. As recently emphasised by MBS, "oil should be treated as an investment, nothing more, nothing less. It is an investment. [Saudi Aramco] is a company that has a value…You must own it as an investment. It should not be owned as a primary commodity or a major source of income…The income of the kingdom of Saudi Arabia will be generated from investment instead of oil. Technically on paper, our income will be provided by investment".

This view represents departure from past thinking where the oil sector has been seen as a major source of income, the bedrock of the economic and political stability of the country, and a key sector to promote diversification and industrialization and add value to the economy. But this new way of thinking also implies that the ultimate success of the IPO of Saudi Aramco will be linked to the quality of the investment decisions and whether the investment of the proceeds of the partial sale of Aramco will be used to transform the Saudi economy.

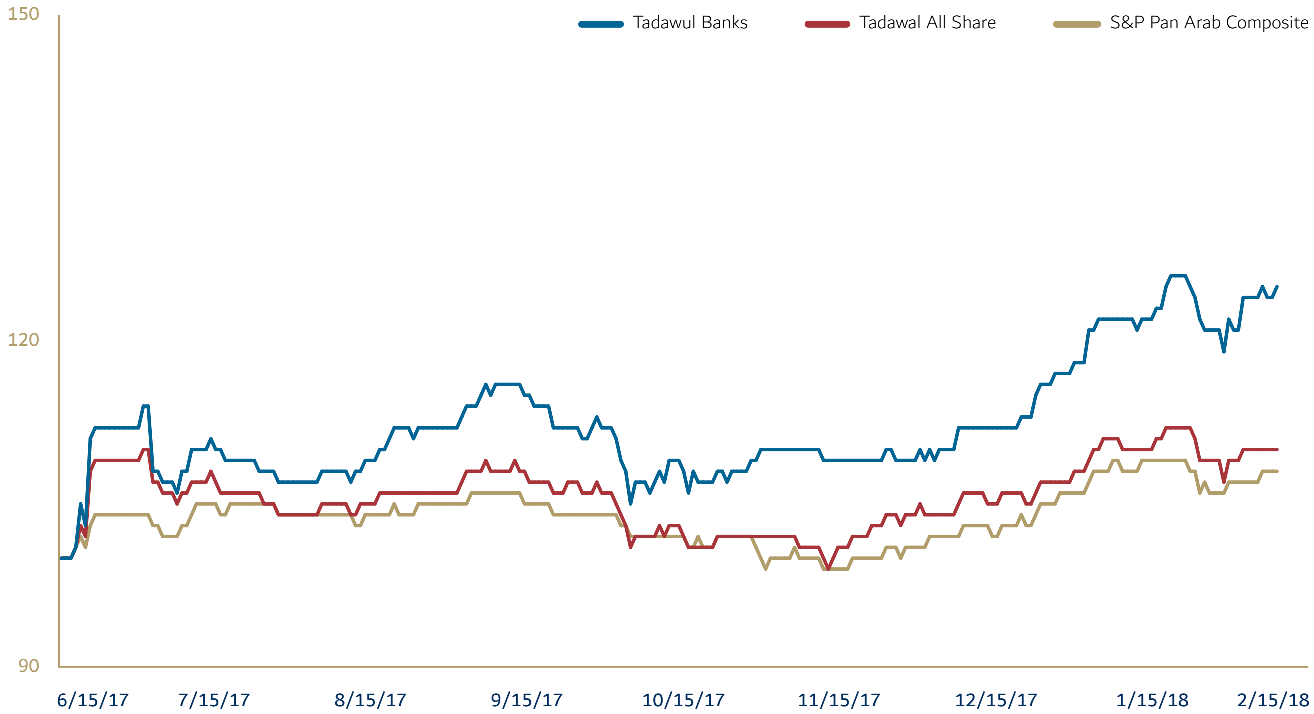
Saudi Banks Bull Case 2.0

Last June, we shared with our clients our positive stance on Saudi Banks.

At that time, our view was that the market was too pessimistic on Saudi Banks, mainly because of the perception that their assets quality was at risk due to the prolonged period of low oil prices. We felt this bearishness was unwarranted as Saudi banks had very large buffer of provisions for loan losses. But there were other reasons to increase our allocation to the sector, namely improving net interest margins, better system liquidity following the tapping of the international debt market, strong capital adequacy ratios, attractive valuations and expectations of increased dividend payouts.

Fast forward to March 2018 the sector (as measured by Tadawul Banks Index) outperformed the broader Saudi equities market as well as the regional benchmark S&P Pan Arab Composite Index with a total return of 28% over the period (see chart below).

Performance of the Tadawul Banks Index vs. Tadawull All Share index and S&P Pan Arab index
(June 2017 - March 2018)



Is it time to take profit or is the bull case intact? Below we revisit the fundamentals of Saudi Banks and discuss whether an overweight stance can still be justified.

The sector outperformed the broader Saudi equities market as well as the regional benchmark S&P Pan Arab Composite Index with a total return of 28% over the period

Rising Net Interest Margins

As highlighted in the previous edition of Perspectives, the United States and US dollar-pegged countries have entered into an era of rising interest rates.

Saudi Banks are major beneficiaries of rising rates. Indeed, the yield on the loans they provide to customers rise alongside the benchmark interest rates. But interestingly – and unlike in other countries – their cost of funding does not rise in a linear way as a large part of their deposit base is interest free. This is very prominent in the case of Al Rajhi Bank that has a non-interest bearing base close to 95% of its total deposit.

The net interest margins of Saudi Banks are thus expected to rise going forward, especially for those with "sticky" current accounts and saving accounts (CASA) deposit base.

SAIBOR and LIBOR used to move together given the SAR peg with the dollar. That being said, the SAIBOR has been trading most of the time above the LIBOR since 2009. This gap widened significantly in 2016 and early 2017 due to liquidity constraints in Saudi. But over the last few months, these constraints have eased (the loan deposit ratio for Saudi Banks is now at 86%, its lowest level since January 2016) and the gap between LIBOR and SAIBOR has been closing. We expect the two rates to move together going forward.

The United States and US dollar-pegged countries have entered into an era of rising interest rates.

Rising Dividends

From our point of view, we have always thought that banks able to raise their dividends are generally rewarded by the market as most investors view this as a positive sign on the quality of the assets. The importance of higher dividends is particularly relevant in this environment of low growth and high capitalization levels.

While we were expecting some Saudi banks to send strong signals to the market by rising dividends, what took place over the last 12 months was even better than what we hoped.

As shown on the table below, some Saudi banks increased their dividend for the full year by more than 50%. One of them even distributed a 50% bonus shares.

Semi-annual dividends for selected Saudi banks (June 2016 – December 2017)

Cash dividends	H1-16	H2-16	H1-17	H2-17	FY Growth
SABB	0.35	0.35	0.71	0.71	103%
RJHI	0.75	1.50	1.50	2.50	78%
Samba	0.45	0.50	0.75	0.75	58%
Bank Al Bilad	-	0.50	0.30	0.40	40%
ANB	0.45	0.45	0.55	0.65	33%
Riyad	0.35	0.30	0.35	0.38	12%
NCB*	0.60	1.00	1.10	0.60	6%
BSF	0.55	0.50	1.05	na	na

*Announced 50% bonus shares

Growth opportunities

At the end of last year, Saudi Arabia announced the 2018 budget with the largest spending target within the region, with a year-over-year growth of 10%, mainly driven by an expansion of capital expenditure in order to support economic growth.

This improved macroeconomic context is a clear positive for the banks which are the best positioned to capitalize on project finance lending opportunities. January statistics showed that the private sector loan growth fell -0.9% year on year in Saudi, which represents the 11th consecutive month of year-on-year declines. At the same time, lending to the government was up 47.0% year on year. There is a reasonable expectation of a cyclical upturn in the Saudi (and the rest of GCC in 2018), but this is predicated on the government loosening spending and being the primary driver behind stronger domestic investment and consumption. Subdued lending to the private sector will act as a constraint on the overall pace of recovery, and the sectors that are set to outperform are those that will benefit directly from the uptick in public spending. This also applies to Banks.

When it comes to corporate lending, we expect that the adoption of a new bankruptcy law to ultimately boost SMEs credit growth.

Looking from a more medium to long-term perspective, Saudization measures (see our February edition) are sending more Saudis into the job market. Women being allowed to drive should also rise their participation to the job market. Altogether, these societal changes should benefit retail banking, spurring growth into mortgages, auto loans, credit cards, and personal loans.

As a remainder, Saudi Arabia is an underbanked industry with no more than 11 players. The banks in place should thus strongly benefit from these cyclical and structural forces.

Valuations, Flows and Risks

Valuations

The Saudi Banks rally highlighted in our introduction has obviously pushed valuation ratios upward. On a price-to-book basis, the sector trades at 1.48 times compared to 1.18 in mid-2017. Still, this ratio is well below what it was a decade ago. To also put things in context, the average Return on equity for Saudi banks is 14%. Last but not least, the sector trades at an average dividend yield of 4.2% versus an average of 3.0% historically.

Flows (and the Index inclusion story)

Another positive driver for Saudi banks going forward could very well be foreign flows ahead and during the inclusion of Saudi equities into major indices.

Indeed, Saudi Arabia is on the watch list of global index providers such as MSCI and FTSE. Trillions of dollars are benchmarked on these indices and the inclusion of Saudi could very well bring several billion dollars of inflows into stocks listed on the exchange. Banks are a major component of the local market and as such should attract both active and passive flows. This is particularly true for large banks.

Banks are a major component of Saudi market

Bank	Weight (%)
Al Rajhi Bank	14.2
NCB	7.6
Samba	4.6
Alinma Bank	4.0
Riyad Bank	2.7
SABB	2.2
BSF	1.8
ANB	1.6
SAIB	1.1
Bank Albilad	1.1
Alawwal Bank	0.7
Total	**41.8**

Weight of banks in MSCI Saudi Arabia

Risks – Zakat claims

Zakat is an Islamic tax paid by Saudi Arabian companies on behalf of their Saudi Arabian national shareholders. It is based on the net book value and the official zakat rate is 2.5%. Foreign shareholders of KSA banks do not pay Zakat but pay a 20% income tax. Zakat and income tax are now accrued on a quarterly basis and are charged to retained earnings. Banks pay cash dividends net of Zakat.

Zakat levels significantly vary across banks due to i) deductions (depending on the balance sheet mix), ii) foreign shareholders percentage, iii) certain long term investments and; iv) banks' methodologies of calculations.

It is a long drawn dispute between Saudi banks and the General Authority of Zakat and Taxes (GAZT) on a disallowance on certain long term investments (such as leases, mortgages, etc.). The banks are contesting for $2.6 billion in total and if the verdict goes in favor of the Authorities, then the banking sector has to cough up this amount.

We do believe that investors' concerns over additional Zakat payments Saudi banks imposed are broadly overstated.

If the appeals court was to rule in favor of the GZAT, there will be no P&L impact and any payments made will only impact the shareholders' equity. Despite the potential one-time impact, Saudi banks are generally well positioned to absorb the impact of Zakat. For instance, Al Rajhi Bank, our top pick in Saudi, has a Tier 1 ratio of 22.2% (made up entirely of core capital).

Overall, we expect an impact on banks capitalization ratios (CET) of 50 basis points (see details in the table below). The aggregate new capital adequacy ratio for Saudi banks will be 19%, which is still a very healthy one.

Once a final verdict on this issue is reached, it will help lift an overhang that has been lingering over the sector for many years now.

Investors' concerns over additional Zakat payments Saudi banks imposed are broadly overstated

Contested Zakat liabilities (SAR amount and % of equity)

	Amount	% of Equity
NCB AB	-	0.00%
ALINMA AB	-	0.00%
ARNB AB	116,000	0.50%
BSFR AB	156,000	0.50%
RJHI AB	723,000	1.30%
SABB AB	433,000	1.40%
ALAWWAL AB	281,600	2.20%
RIBL AB	896,000	2.40%
SAMBA AB	1,309,000	3.00%
SIBC AB	573,000	4.40%
BJAZ AB	462,200	5.70%
ALBI AB	561,100	7.70%

Conclusion

We believe there are many reasons to stay bullish on Saudi banks in 2018:

1. Net Interest Margin expansion on the back of better liquidity and increasing interest rates;
2. attractive valuations with strong dividend yields versus historical average;
3. better growth prospects compared to 2017 on the back of higher oil prices, expansionary budget and mega projects;
4. strong capital basis and coverage ratios and;
5. the potential inclusion of Saudi in the MSCI & FSTE indices.

When it comes to individual names, we always prefer large banks due to better credit underwriting capabilities, lower costs of funding, better ability to control costs and to source deals.

We are still buyers of Rajhi Bank and SAMBA at these levels. Both trades at a dividend yield above 6.0% and as the aforementioned catalysts materialize both stocks are expected to move back to 4.5% dividend yield, which is closer to their historical average.

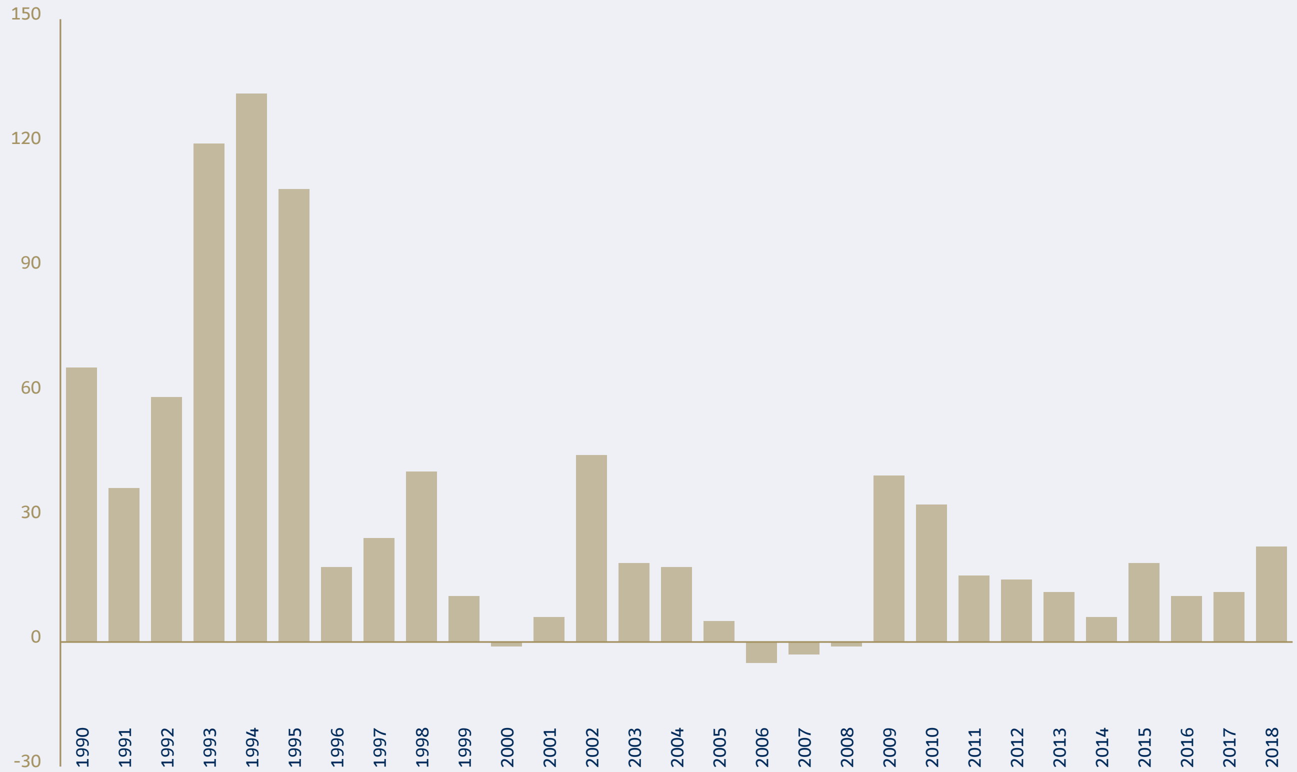
Troubles ahead for LEBANON?

At the time when global risk assets continue to perform reasonably well and while most Middle East economies are on the path of recovery, Lebanon seems to be facing some serious macro-economic (and geopolitical) issues.

Indeed, over the last few months, Lebanese bonds have tumbled and CDS (the cost of insuring their bonds) have moved sharply upward to reach 600 basis points at the end of last year. Meanwhile, bank deposits are growing at their slowest pace since the end of the civil war almost 30 years ago (see chart below). And as the government revenue can't keep up with spending as the economy splutters, the budget deficit is ballooning to more than 10 percent of gross domestic product.

It was thus no surprise to see the IMF sounding the alarm bell earlier this year by saying that the Lebanon economy is on an unsustainable path and required urgent action. Meanwhile, politicians are clashing ahead of the May elections.

Lebanese banks see capital inflows slow amid uncertainty



For sure, part of the tension on bond yields and the slowdown in capital inflows can be put on the back of the geopolitical crisis that took place last November when Prime Minister Saad Hariri resigned (before coming back to power a couple of weeks afterwards). Politics aside, the Lebanese economy is facing some cyclical and structural issues. Below, we look into details at the set of challenges Lebanon is currently facing and how the situation could eventually escalate.

Bank deposits are growing at their slowest pace since the end of the civil war almost 30 years ago

Lebanon's Economy at a glance

The 1975-90 Lebanese civil war seriously damaged Lebanon's economic infrastructure, cut national output by half and had major consequences for Lebanon's position as a Middle Eastern "warehouse" and banking hub.

After the war, the central government regained its ability to collect taxes and control over key port and government facilities. As a result, GDP per capita expanded 353% in the 1990s. Economic recovery has been helped by a financially sound banking system and resilient small- and medium-scale manufacturers, with family remittances, banking services, manufactured and farm exports, and international aid as the main sources of foreign exchange. Lebanon's economy has made impressive gains since the launch of "Horizon 2000," the government's $20 billion reconstruction program in 1993. Between 1990 and 2006, Lebanon enjoyed considerable stability, Beirut's reconstruction was almost complete, and increasing numbers of tourists poured into the nation's resorts.

But the month-long 2006 war severely damaged Lebanon's economy, especially the tourism sector. Over the course of 2008 Lebanon rebuilt its infrastructure mainly in the real estate and tourism sectors, resulting in a comparatively robust post war economy. Major contributors to the reconstruction of Lebanon include Saudi Arabia (with $1.5 billion pledged), the European Union (with about $1 billion) and a few other Arabian Gulf countries with contributions of up to $800 million.

Given the frequent security turmoil it has faced, the Lebanese banking system has adopted a conservative approach, with strict regulations imposed by the central bank to protect the economy from political instability. These regulations have generally left Lebanese banks unscathed by the financial crisis of 2007–2010 as the Lebanese economy experienced continued resilience over that difficult period of time. But this resilience came at the price of a ballooning debt to GDP ratio, which is among the highest in the world (more on this later).

Over the last few years, the Lebanese economy has been underperforming though, as it is bearing the burden of civil wars in the neighboring countries, which has also impacted its trade. For instance, the Syrian conflict has had adverse ramifications for Lebanon. Around 1.5 million displaced Syrians have taken refuge in Lebanon since March 2011. This has further pushed the Lebanese people into poverty and put an additional burden on its economy. The Lebanese economy is largely dependent on Syria – not just as a trading partner, but also as a significant transit route.

Yet a steady rise in sectors like service, finance, construction and tourism, accompanied by financial aid from countries such as Saudi Arabia, has helped Beirut's economy. The services and banking sector predominate, accounting for almost 70 percent of the country's gross national product; agriculture constitutes less than 10 percent and the industrial sector, the remaining 20 percent.

In effect, the Lebanese economy has become service-oriented, with major thrust on banking and tourism. In 2016, Lebanon's real GDP growth accelerated slightly to reach an estimated 1.8 percent, compared to 1.3 percent in 2015. This was driven by an improvement in the real estate sector as well as continued increase in tourist arrivals.

At the same time, remittances have averaged about 20 percent of the country's GDP annually over the past 10 years — with an estimated 60 percent coming from Gulf countries. According to an estimate, three Gulf countries accounted for 76 percent of new foreign direct investment projects in Lebanon from 2003 to 2015. Saudi Arabia has injected about $4 billion into Lebanese banks to help Lebanon maintain a healthy economy.

In 2016, Lebanon's real GDP growth accelerated slightly to reach an estimated 1.8 percent, compared to 1.3 percent in 2015

Lebanon’s Energy Dependence

Natural gas became central to Lebanon’s economic development in 2009, with the initiation of the Arab Gas Pipeline (AGP) which started supplying Egyptian gas to the Beddawi power plant in the north of Tripoli (Lebanon). This however stopped as a result of frequent disruptions caused by payment delays and explosions targeting the pipeline.

Before the AGP, the Gasyle pipeline became the center of attraction, as Syria and Lebanon signed a 25-year contract (in 2003), by which Syria would export gas to the Beddawi power plant; this project has run into several bottlenecks such as insufficient production and the Syrian crisis. Nevertheless in 2006, the AGP was initiated and designed to transport gas from Egypt to Jordan, Syria and Lebanon, which turned futile due to the 2011 uprisings.

Fresh discoveries in the East Mediterranean have given a new ray of hope for the energy-importing countries of the region, particularly Lebanon. The Lebanese Exclusive Economic Zone (EEZ) is estimated to have around 122 trillion cubic feet (3.45 trillion cubic meters) of recoverable natural gas, in addition to nearly 1.7 billion barrels of recoverable oil. The development of these reserves will help the Lebanese economy to grow and come out of its import dependence syndrome.

A precarious financial position

Lebanon’s relative economic stability rests on the Lebanese pound that has been pegged within a narrow range of 1,500 to the US dollar for nearly 20 years, backed by central bank foreign exchange reserves of $44 billion, equal to almost 90% of GDP.

This depends on attracting large amounts of cash from overseas into Lebanese banks, which requires high interest rates. To be able to remunerate the country’s banks at a high enough rate to make this possible, the government must issue a huge amount of debt, which now stands at $79 billion, or 150 percent of GDP, the third highest level in the world after Japan and Greece. In fact, for the 6th year in a row since the Arab Spring, Lebanon’s debt is growing five times faster than its economy.

Thanks to the skill and creativity of Riad Salamé, governor of the central bank since 1993, Lebanon has been able to assure depositors and investors that this debt pile is sustainable.

It also owes much to the Lebanese diaspora, variously estimated at between 8 and 20 million people compared with the 4.5 million Lebanese living at home. They regularly send $7bn to $8bn a year into Lebanese banks.

Last year, when such flows began to slow dangerously, Mr. Salamé used what he himself calls financial engineering — heavy discounts on local currency bonds delivering windfall profits to banks and others on the condition that they invested the proceeds in dollar assets — to bring total inflows for the year to about $15bn.

He has had to use fresh enticements this year to keep the flows coming, in the form of yield enhancements on some bonds and deposits, and cheap loans. There are fears however, that Mr. Salamé creativity will at some point reach its limits as Lebanon is now being trapped into a vicious circle of low growth, rising twin deficits and ballooning debt.

The precarious financial position reflects the increasingly dire state of the economy and deteriorating governance, with Lebanon slipping down Transparency International’s corruption ranking to 143rd of 180 countries. Parliament only managed to pass a budget in 2017 for the first time in 12 years. There’s been a garbage collection crisis and efforts to open up the electricity and telecommunications industries to bring in vital foreign investment have floundered.

Meanwhile, real GDP growth is projected to remain anemic in 2018 at around 2 percent per year (representing half of Lebanon’s average in the post-civil war period until 2014) against a very tenuous fiscal position. This includes, as already mentioned, a high and increasing debt-to-GDP ratio (the IMF said it is likely to reach 180% of GDP in 5 years), a current account deficit that currently stands at 20 percent (due to declining remittances and rising merchandize imports) and a fiscal deficit of 10 percent. With more than 70 percent of expenditures going on government salaries and debt servicing while up to 10 percent goes to subsidizing electricity, it leaves very little room to the government to cut spending.

These three indicators (the debt and the dual fiscal and current account deficits) are not only sizeable as such, they are also among the largest in the world.

And the situation could even deteriorate further (and quickly) in case of a surge in oil prices, increases in international interest rates, or a depreciation of the euro, which have so far been favorable to the Lebanese economy. One can only hope that regional instability will be reduced and that the political process will not revert back to stalemate. But even under the most promising scenarios in these two areas, the economic challenges are daunting.

Will Lebanon be able to finance its chronic twin deficits?

The chronic account and trade deficits mentioned earlier are exposing the country's financing needs. As mentioned earlier, Lebanon has been able for many years to attract capital from abroad to address this gap through overly generous interest rates offered to domestic banks.

The private-sector bank deposits, mainly from millions of Lebanese living abroad sending money back, keep the banks stable and defend the dollar peg. As long as the money kept flowing, banks are happy to gobble up government debt.

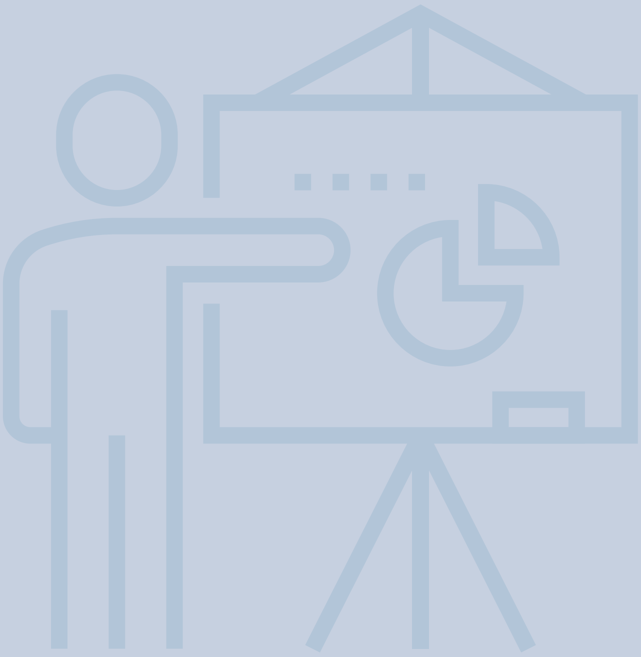
While deposit growth slowed to 3.8 percent last year because of the Hariri incident in November, central bank Governor Riad Salameh said the financial system has demonstrated its resilience. Lebanon saw outflows of $2 billion after Hariri announced his surprise resignation. Some banks sent offers by text message and cold-called Lebanese living abroad with offers of higher interest rates. One bank is offering as much as 6 percent on deposits of $1 million or above. The rate rises to 10.50 percent for high local-currency deposits. The $2 billion has gradually returned, with inflows exceeding outflows since Dec. 10, Salameh said in an interview.

But this practice may soon be coming to an end. As the high level of interest rates paid by the banks is remunerated by the government which needs to finance itself on the debt market. And as mentioned in the introduction, things are getting more complicated on that front as well.

There are, broadly, two types of investors in Lebanese Eurobonds: dedicated locals and adventurous foreigners. The latter have taken fright after the shock resignation of Saad Hariri, Lebanon's prime minister. The yield on the benchmark ten-year dollar bond spiked from 6 percent to a high of 8.5 percent a week later, before falling back a little (the 10-year now trades at 8 percent).

Part of the reason is a big increase in foreign ownership over the past 18 months. By some estimates, foreign investors hold about $8 billion, or 30 percent, of outstanding Eurobonds. This is more than twice the proportion of a few years ago, which is now a risky situation.

To keep the country solvent, Lebanon needs to maintain the confidence of its creditors. Foreign holders might be very quickly discouraged, especially if geopolitical tensions rise and/or the government fail to "put its house in order". And if the foreigners panic, the "dedicated locals" could very well lose faith.



Lebanon will seek to raise funds for a $16 billion infrastructure program at a donor conference scheduled next month in Paris

Is there light at the end of the tunnel?

In a recent interview, the Deputy Prime Minister Ghassan Hasbani said that the gravity of the situation is not understood by everyone and that the time has come for an international aid package that will force Lebanon to reform. Still, the political elite does not seem willing to actually reform the system that is serving its interests through excessive spending and debt financing.

Most likely, politicians should be able to buy time as they will most likely get help given the Syrian refugee crisis by collecting some funds through another international conference. Indeed, Lebanon will seek to raise funds for a $16 billion infrastructure program at a donor conference scheduled next month in Paris. While it might be seen as a more than welcome relief, there are questions marks on where this money might come from.

Some Gulf countries, including Saudi Arabia, have been thinking twice before helping Lebanon financially like they did in the past for political reasons. Relations with the Saudis appear to be improving though. Prime Minister Saad Hariri received a statesman's welcome in Riyadh earlier this year. Saudi Arabia will attend the donor conferences in Paris and the one which will take place in Rome later in the year.

Some Gulf countries, including Saudi Arabia, have been thinking twice before helping Lebanon financially

Long-term prospects could be bright

As far Lebanon's economy is concerned, it could get a fresh "boost" once the offshore oil/gas resources in the Levant are developed. According to statistical information and data provided by the Ministry of Energy, it could be assumed that "Lebanon's total net revenues from gas extraction will exceed $600 billion, to reach $1000 billion" (possibly by the year 2026). It is expected to facilitate Lebanon in overcoming its public debt and provide opportunities to the youth.

Notably, Lebanon and other stakeholders' interest in the East Mediterranean gas ventures can also be seen through the prism of cooperation. For instance, a project, known as East Med, involves a "2,000 kilometer long pipeline to channel offshore reserves in the Levantine Basin in the Far-East corner of the Mediterranean to Greece and Italy, at a cost of up to 6 billion Euros." Also, enormous funds will be needed in the coming years for gas production facilities, for building new pipelines for export, etc. The energy discoveries have the potential to positively change the economics of the East Mediterranean region, and most significantly the Lebanese economy.

Beyond the oil sector, tourism, services and construction could also witness a boom. But a sector like tourism is contingent on the resolution of the Syrian refugee crisis to a large extent.

Although, its economy has been on a roller-coaster ride in the recent years, it appears that the economic model of diversification has been a successful sign that will stabilize the economy in the long run. Yet, the path to that end looks easier said than done.

Conclusion:

As mentioned above, the Lebanese economy is far from healthy but it is not on the brink of bankruptcy, at least for now. The foreign exchange reserves of the Central Bank have climbed to $42 billion, which is enough to cover more than two years of imports. Public debt is a daunting 150 percent of GDP, but it has been higher in the past. And very importantly, Lebanon can rely on a very supportive Lebanese diaspora, who has been sending back home billions of dollars on a regular basis. This makes the country's situation very different from other struggling countries such as Greece.

Still, Lebanon's Central Bank has managed so far to absorb the burden of the debt through its repeated resort to financial engineering, drawing on foreign currency in banks that are already overloaded with treasury bills. However, such policy is unsustainable and will not make up for the absence of economic planning and structural reforms.

Real GDP growth has slumped since 2010 to below 2 percent, reflecting the impact of the Syrian conflict. Syrian reconstruction and an offshore oil and gas bonanza could turn things round, but not for some time, if at all. The revival of tourism has been positive, but could be undermined by new security crises.

Unless drastic changes are initiated to reabsorb the budget deficit, such as privatizing the national electricity utility, Electricité du Liban, which is responsible for a significant share of the deficit, and kick-starting rapid growth, Lebanon is indeed edging towards a very difficult situation.

In the short to medium-term, keeping Lebanon solvent depends on maintaining the confidence of creditors. Lebanon relies on private-sector bank deposits, mainly from millions of Lebanese living abroad sending money back, to keep the banks stable and defend the dollar peg. As long as the money keeps coming in, banks would continue to buy government debts. But if these flows start to vanish, expect bond yields to rise further and the peg to come under pressure. For those exposed to assets in the Levant, the Lebanese situation should be closely monitored as one can even fear some ripple effects on other countries within Levant (e.g. Jordan).

We do not own any position in Levant within our funds.

And very importantly, Lebanon can rely on a very supportive Lebanese diaspora, who has been sending back home billions of dollars on a regular basis. This makes the country's situation very different from other struggling countries such as Greece

FINAL WORDS

As highlighted in this edition, international markets are becoming more challenging and portfolio construction approaches might have to evolve.

Meanwhile, there are plentiful of exciting stories in our Middle East region. Saudi Aramco IPO is likely to attract considerable attention from the international community. But this is just the beginning of a trend. With more IPOs to come and the inclusion of Saudi and Kuwait into MSCI and FTSE indices, our region is ripe to gather foreign flows in the years to come. As we have often highlighted in our writing, the “beta” story is not the only one to consider. There are indeed plenty of alpha opportunities for astute portfolio managers.

While our forecasts and views are always subject to change, our commitment to serve our clients is not. We remain at your full disposal for any specific issues you would like to discuss, so please don’t hesitate to contact us.

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