بنك الإمارات دبي الوطني
Emirates NBD

Credit Note
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Kingdom of Bahrain Debt Update

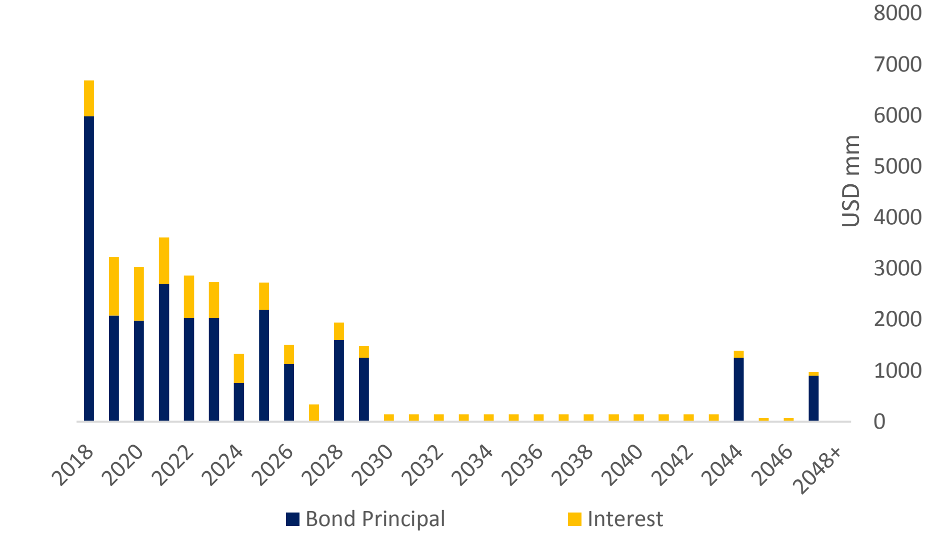
The Kingdom of Bahrain has been one of the most prolific issuer of sovereign debt in the GCC. The Bahrain government increased social spending earlier in this decade to promote peace and prosperity and therefore has been recording budget deficits since 2009 – much before the low oil prices exacerbated the deficit situations. Currently it has about $35.9 billion of debt including $11.3 bn in USD denominated bonds and $3.6 bn in USD denominated sukuk. **Bahrain is rated B+/Stable, B2/Negative and BB-/Stable by S&P, Moody's and Fitch respectively.**

Bahrain Debt

Bahrain mainly raises debt via public market issues.

- Bahrain's current debt obligation of USD $35.9 billion is made of a) bonds (including TBs) of $25.88 bn and b) committed interest expense of $10.07 bn.
- Debt is denominated in USD (58.16%) and BHD (41.84%).
- 84% of the debt is at fixed interest rate and remainder at zero coupon (mainly T-bills).
- The debt is 100% in bullet form with no amortisation requirements.

Bahrain Sovereign Debt



Source: Bloomberg, Emirates NBD Research

Unlike Saudi Arabian and Omani governments that engage in borrowings in the loan market, Bahrain's debt is mostly in domestic and international capital markets. International investors are reasonably familiar with the name and therefore access to funding has not been an issue in the past. However, lately Bahrain's credit rating has been falling, from A/A2 in 2007 to B+/B2 now by S&P and Moody's respectively, as Debt/GDP has been increasing by circa 10% every year since 2014. In addition expectation of frequent new supply from Bahrain has dampened investors' enthusiasm and consequently investors' demand for high return is making it increasingly expensive for Bahrain to raise new debt.

Last month, Bahrain shelved plans to raise debt via longer dated bond issues mainly due to high pricing demanded by investors. However, with over $3.5 billion in projected budget deficit and several upcoming bond maturities this year, we think that new debt offerings will have to surface up again soon.

Bahrain USD bonds and sukuk

	Ticker	Cpn	Maturity	Amount $mm	YTW %
Bonds					
	BHRAIN	5.5	3/31/20	1,250	4.64
	BHRAIN	5.875	1/26/21	975	5.26
	BHRAIN	6	9/19/44	1,250	7.80
	BHRAIN	6.75	9/20/29	1,250	7.77
	BHRAIN	6.125	7/5/22	1,500	5.69
	BHRAIN	6.125	8/1/23	1,500	5.89
	BHRAIN	7	1/26/26	1,125	7.03
	BHRAIN	7	10/12/28	1,600	7.54
	BHRAIN	7.25	9/20/47	900	8.36
Sukuk					
	BHRAIN	5.624	2/12/24	1,000	5.58
	BHRAIN	6.273	11/22/18	750	3.36
	BHRAIN	5.25	3/20/25	850	5.59
	BHRAIN	6.875	10/05/2025	1,000	6.61

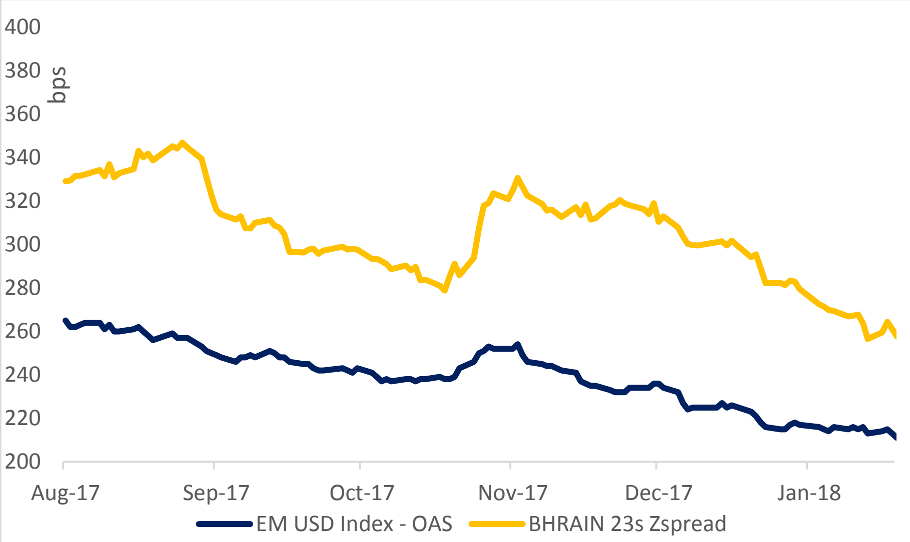
Source: Bloomberg, Emirates NBD Research

Bahrain has established yield curves in USD and BHD currencies. And although Bahrain’s credit rating is deep in the high yield category, investor demand for Bahrain bonds is healthy particularly because of well-established expectation of support from its neighbours in times of need.

That said, ahead of its recent issuance of $1 billion in 10.5 years sukuk, the secondary market prices on Bahrain curve fell noticeably. This may indicate the possibility of saturation in demand as well as investors having hit single name limits on Bahrain.

Volatility in Bahrain bonds has increased recently due to the altered mix of investors on its bond registers after the country lost its investment grade rating in 2016. Holdings by real money accounts have reduced and that by fast money / hedge funds has increased.

Bahrain bond: Z-spread (bps) vs EM Index OAS



Source: Bloomberg, Emirates NBD Research

Also given Bahrain's low level of FX reserves, investor concerns around its external vulnerabilities are high which add to the bond price volatility.

2018 Budget

Bahrain's 2018 budget is based on oil price assumption of $55 / b and reflects a deficit of USD 3.5 billion. The government has introduced numerous measures since 2015 such as subsidy cuts and imposition of fees to control public finances in response to a revenue side shock. And therefore, rating agencies expect Bahrain's fiscal deficit to reduce from over 10% in 2017 to 7.5% by 2020. Main highlights of the 2018 budget are as below:

- Recurrent expenditures are lower by 15% compared to 2016 levels and project expenditures are lower by 29% from 2016. Government employees' expenditure is to be capped at 2016 levels with a 75% reduction in promotions and other items.
- Non-oil revenues are projected to increase to USD 1.7 billion in 2018 compared with USD 1.1 billion in 2014.
- Implementation of VAT is likely to be in late 2018 though delays are expected given the magnitude of the technical challenges involved.
- Interest expense represents 20-25% of total expense. All of the deficit is funded by debt with debt / GDP increasing from 44% in 2014 to 82% as of December 2017. This is expected to reach circa 90% by end 2018 and 100% by 2020. Net debt to GDP was about 60% in 2017 and likely to be about 74% in 2020. The government is believed to have legislated a debt ceiling of about 102% of GDP.
- Non-oil sectors contributed 81% of Bahrain's GDP as at September 2017. No single industry accounts for more than 20% of the real GDP.
- Bahrain plans to spend $15 billion over the next two decades on developing oil and gas reserves. Bahrain gets most of its oil from the Abu Sa'afa field shared with Saudi Arabia (it is entitled to 50% of production, but has sometimes received significantly more as a form of support). Together with Saudi, it is constructing a new pipeline between the two countries to carry 360k bpd crude oil. This is to be completed by 2018. Bahrain has also increased the volume of gas produced to 650mcf per day by increasing exploration and development and is constructing a

new gas processing facility for 350mcfpd. Recently it discovered large oil reserves of circa 600 million barrels off its west coast. Further details on this are not yet available.

Bahrain Budget Highlights

USD mm	2015	2016	2017 Est.	2018 Budget
Oil revenues	4,241	3,820	4,342	4,777
Non oil revenues	1,190	1,227	1,482	1,530
Total revenue	**5,431**	**5,047**	**5,824**	**6,307**
Recurrent Expense	8,287	8,302	8,417	8,929
Projects Expense	1,180	1,093	881	878
Total expenditure	**9,467**	**9,395**	**9,298**	**9,807**
Surplus / deficit	**(4,036)**	**(4,348)**	**(3,474)**	**(3,500)**
Deficit % of GDP	13	14	10	9
Recurrent expense includes debt servicing				

Source: Bahrain MOF, Emirates NBD Research

Given large fiscal deficits and sizable due amortization payments, the Bahrain government’s gross financing needs will reach more than 30% of GDP over the next two years.

Despite high debt levels, Bahrain is in a net external creditors position (43% of GDP) due to large foreign assets held by the wholesale banking sector.

Bahrain is a net exporter. Exports in 2016 were USD26.1 billion while imports were $20.6 billion, giving a trade surplus of over $5.5 billion. Exports are generally refined oil and alumina while imports are dominated by crude oil and raw alumina.

Foreign exchange reserves at the Central Bank of Bahrain are low and very volatile, covering only around two month of goods and services imports. Reserves are mainly invested in US treasuries and are held offshore. Government access to international capital markets is now crucial in supporting the central bank's low level of foreign currency reserves.

Bahrain FX reserves

USD'mm	2013	2014	2015	2016	2017
FX Reserves	5,354	6,055	3,394	2,447	2,635
% of GDP	16.5	18.1	10.9	7.6	7.6

Source: Bahrain MOF, Emirates NBD Research

Other Credit Considerations

Bahrain is a free market economy with no controls over movements of capital trade and investments. While the current account has been in deficit, overall finance and investments related inflow have been positive in the recent past. Bahrain has bilateral trade agreements with over 40 countries.

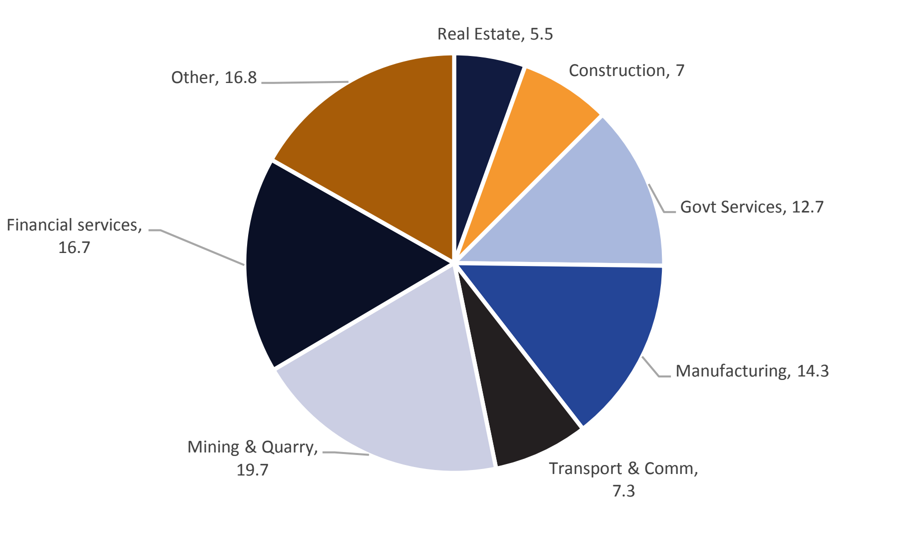
Bahrain has a well-regulated banking sector which is aiding capital inflows into the country. Bahrain's banking sector has a BICRA score of 7 from S&P (on a scale of 1-10, with '1' being the lowest risk and '10' the highest). It has 29 retail banks, 72 wholesale banks and 155 insurance companies. There are 23 Islamic banks. Banking sector assets were $187.5 bn in end 2017 representing more than 500% of GDP. NPLs in the sector have remained range-bound at 5.6% in 2017. The capital adequacy ratio in the sector is amongst the highest in region, with the level being at 19.5% in 2017 vs 19.1% in 2016 and against the central bank's guideline of 12.5%. The government is promoting various initiatives and growth opportunities in Fintech to position Bahrain as a leading regional financial hub. It established Bahrain Fintech Bay and a U$100 million fund to support techno start-ups. A fintech cooperation agreement has also been signed with Abu Dhabi Global Market.

As part of Vision 2030, Bahrain endeavors to :

- Reduce reliance on hydrocarbons,
- Double household disposable income from 2008 levels,
- Investment in ports infrastructure, commodity and cargo terminals, and
- Strengthen the rule of law.

Of all GCC countries, Bahrain's economy is one of the most diversified and therefore has posted decent growth even when oil prices have fallen compared with contraction in Saudi and Kuwait and stagnation in other GCC countries. Non-oil sectors have contributed 80% of nominal GDP on an average since 2010, however government revenues still come mostly from oil.

Bahrain GDP composition in 2017 (%)



Source: Bahrain MOF, Emirates NBD Research

Real economic growth is likely to remain above 2% over the 2017-2020 period, aided by GCC Development Fund supported infrastructure investments. Growth will also be supported by state-owned enterprise projects in oil, gas, and aluminum and strong GCC demand for Bahrain real estate. In addition, the creation of a business friendly environment by virtue of a) offering 100% foreign ownership across all sectors; b) low operating costs and c) strong regulatory framework, is likely to attract international investments.

Bahrain's support from its neighbors is evident by the setting up of GCC Development Fund in 2011 with $2.5bn contribution each from KSA, UAE, Qatar and Kuwait. Qatar's contribution of $2.5bn may not now come through thereby reducing the total fund size from $10 billion to $7.5 billion. The Fund is provided as a grant to be distributed over 10 years. Of this, only $1.4bn has actually been drawn so far. However, USD7.3 billion worth of projects have been identified and awarded to contractors as at end-2017, up from USD1.1 billion in end-2015.

Instances of street protests increased in 2017 and therefore overall security environment in Bahrain is perceived to be tense, as highlighted by S&P. Given these sensitivities, the overall transparency of policy-making is believed to be constrained and accompanied by inconsistent disclosure of information. That said, the baseline assumption is that Bahrain's security forces will continue to prevent the sort of escalation of domestic tensions that would materially affect economic growth.

Bahrain Key Economic Data

	2015	2016	2017e	2018f
Real GDP $bn	30.8	31.8	34.7	35.8
GDP Growth %	2.9	3	3.5	3.3
Population millions			1.5	
GDP per capital $			22,133	

CPI %			1.40%	

Source: Bahrain MOF, Emirates NBD

Credit Ratings

S&P downgraded Bahrain's rating to B+ with stable outlook in December last year citing risks related to low levels of international reserves at the central bank should the country experience sharp deterioration in its access to external liquidity.

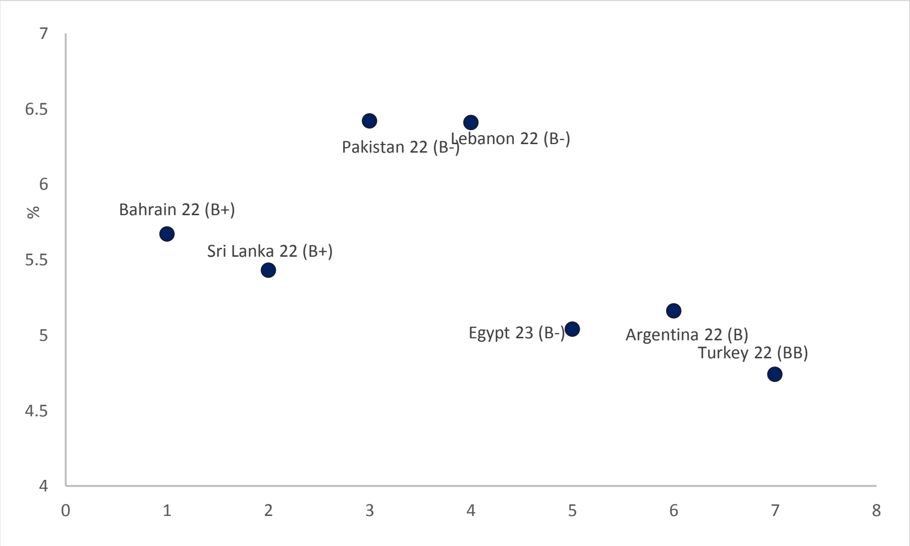
Moody's downgraded Bahrain's rating to B2/Negative citing concerns about the Kingdom's increasing debt burden and lack of a credible clear and comprehensive consolidation strategy. The negative outlook reflects continued downside risks to the rating from high external liquidity risks. Furthermore, although Bahrain has benefited from the support of neighbouring countries during times of stress in the past, such support at this juncture lacks clarity, both in its form and timeliness. A clear, sizable and timely support from one of its financially stronger neighbours could contribute to stabilizing the outlook on Moody's rating.

Fitch revised the outlook on Bahrain's BB+ rating to negative in June last year and downgraded the rating to BB-/stable last month. As per Fitch, Bahrain's ratings are supported by high GDP per capita and human development indicators, a developed financial sector and the boost to external financing flexibility from strong GCC support. The strengths are balanced by double-digit fiscal deficits, high and rising debt, a highly oil-dependent government budget and domestic political tensions that hamper fiscal adjustment.

Relative Value

Despite likely flow of new issues, Bahrain's bonds have received support from international investors due to relative value attractiveness.

Yield on sovereigns USD bonds (%)



Source: Bloomberg, Emirates NBD Research

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