بنك الإمارات دبي الوطني
Emirates NBD

Kingdom of Saudi Arabia debt update

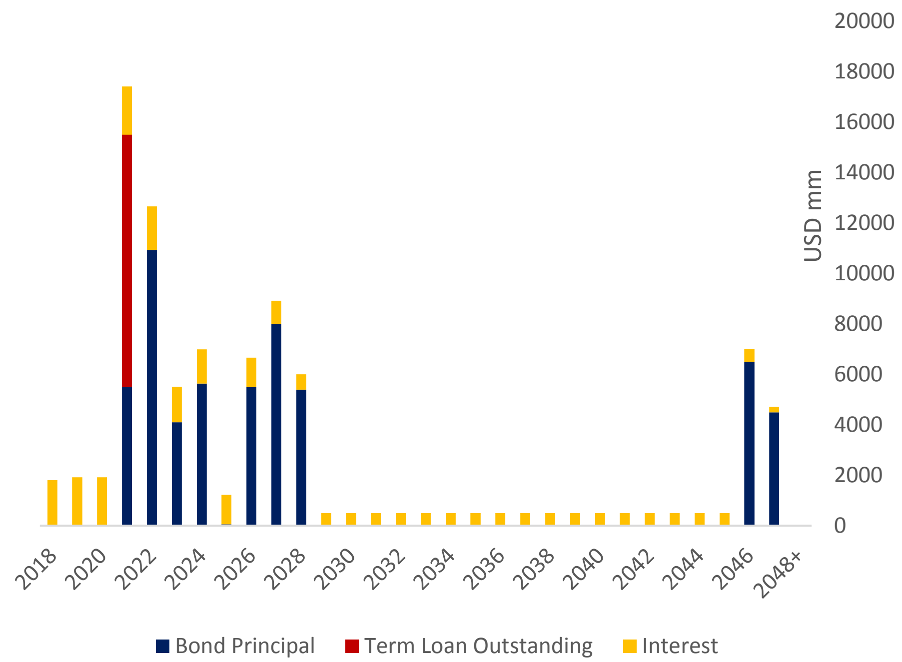
The Kingdom of Saudi Arabia (KSA) currently has $30 billion in dollar denominated bonds and $9 billion in USD sukuk owed to international investors. This represents circa 8% of the government's foreign reserves in Dec 2017 and circa 5.6% of GDP. Adding the debt issued in SAR currency and the debt of government guaranteed subsidiaries, total government debt / GDP is currently circa 17%. While the debt is expected to continue increasing over the coming years to fund budget deficits, the KSA government's aim is to keep debt / GDP levels to below 30%. **KSA is rated A-/stable, A1/stable and A+/stable by S&P, Moody's and Fitch respectively.**

KSA Debt

To fund its budget deficits, KSA began raising debt in the local currency market via issuance of SAR denominated sukuk in 2015/16. In order to preserve liquidity in the local banking system, SAMA (Saudi Arabia Monetary Authority) has since gradually reduced issuance of T-Bills.

- KSA currently has debt obligation of USD $91.2bn made of a) bonds (including TBs) of $56.15bn; b) loan of $10bn and c) committed interest expense of $25.1bn.
- 77% of the debt obligation is denominated in USD with remainder in SAR.
- 100% of the debt is at fixed interest rate and the earliest USD bond maturity is not until October 2021.

KSA Sovereign Debt



Source: Bloomberg, Emirates NBD Research

KSA tapped international capital markets in 2016 and 2017, raising $17.5 billion and $21.5 billion respectively. With oil prices expected to remain in the range of $50/b - $70/b over the coming few years, KSA will need to continue tapping debt markets to fund its budget deficits. Its 2018 budget indicates need to raise SAR 117 billion ($31.2 billion) in debt which we expect to be sourced from USD as well as SAR denominated markets.

Despite expectations of large new issues, KSA sukuk and bonds are currently well bid in the secondary market.

Credit Note
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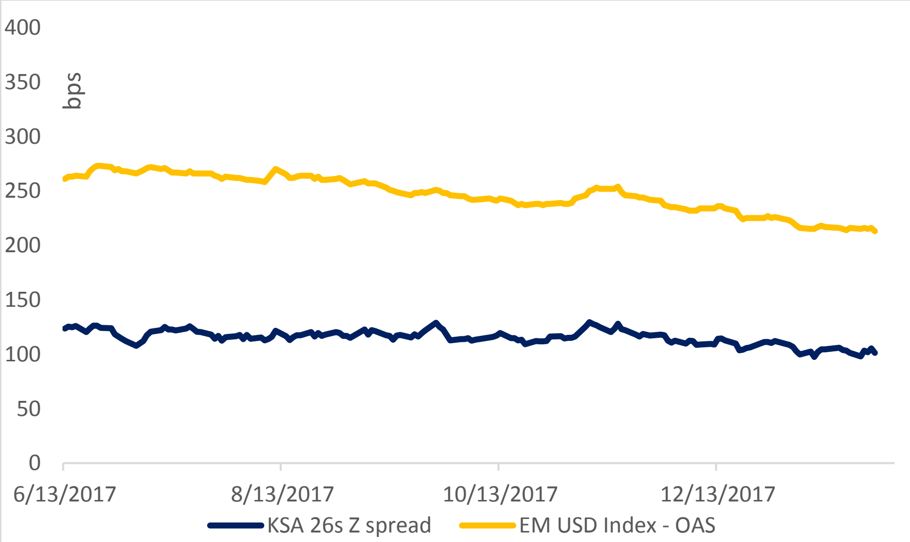
KSA USD bonds and sukuk

	Ticker	Cpn	Maturity	Amount $mm	YTW %
Bonds					
	KSA	2.375	10/26/2021	5500	3.37
	KSA	2.875	3/4/2023	3000	3.61
	KSA	3.25	10/26/2026	5500	4.03
	KSA	3.625	3/4/2028	5000	4.16
	KSA	4.25	10/26/2046	6500	4.85
	KSA	4.625	10/4/2047	4500	4.84
Sukuk					
	KSA	2.894	4/20/2022	4500	3.55
	KSA	3.628	4/20/2027	4500	4.10

Source: Bloomberg, Emirates NBD Research

Although KSA faced several rating downgrades in 2016/17, its current rating still remains one of the highest available in the emerging markets universe. As a result overall demand for KSA bonds has been resilient. Credit spreads on KSA bonds, although weaker than spread on 'A' range rated sovereigns in the developed world, have tightened in the recent years.

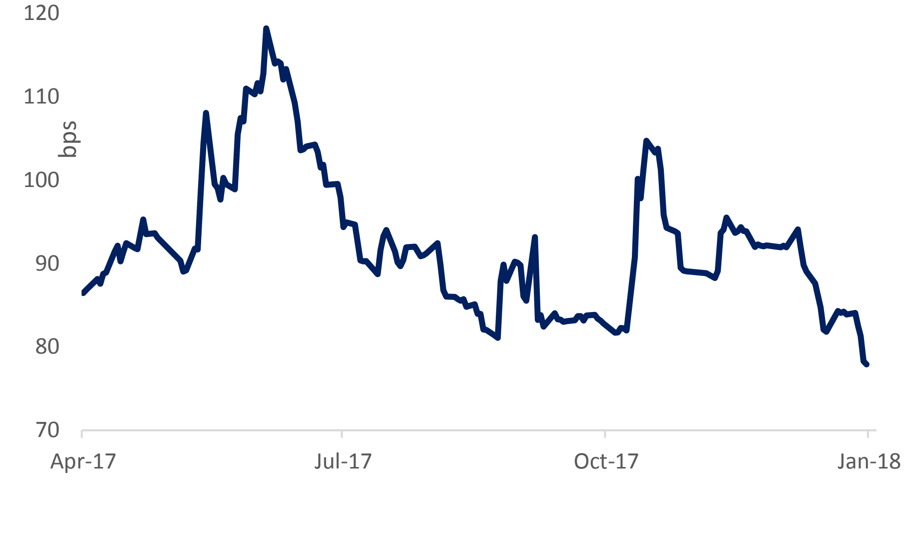
KSA 3.25% 2026 bond: Z-spread (bps) vs EM Index OAS



Source: Bloomberg, Emirates NBD Research

Credit spreads on KSA bonds did widen in June/July last year at the time of diplomatic row with Qatar and then again in November / December when the corruption related arrests happened. However since then, progress has been made on the corruption front, the IMF has raised its economic growth forecast for KSA on the back of rising oil prices and overall progress on reforms and budget balancing have been satisfactory. These factors in turn have led to an improvement in sentiment on Saudi bonds and fueled credit spread tightening.

KSA 5yr CDS (bps)



Source: Bloomberg, Emirates NBD Research

2018 Budget

KSA announced its budget for 2018 in December last year, reflecting a 13% increase in revenue to SAR 783 billion and 10% increase in expenditure to SAR 978 billion. Including the planned spending of SAR 133 billion by other government entities, Public Investment Fund (PIF) and National Development Fund (NDF), total government spending will be circa SAR 1.1 trillion– its highest in the recent history. The budget is believed to be based on assumption of oil prices at circa $50/b

- KSA pushed back the target date for eliminating the government budget deficit to 2023 from 2020, signaling a willingness to support the economy through fiscal stimulus, a move endorsed by the IMF.
- The Government announced a number of new development initiatives aimed at stimulating non-oil growth. Government spending will now be deployed through three key pillars – the annual Budget, National Development Funds and the Public Investment Fund. Together they will coordinate and amplify the impact of government spending over the coming years.
- In 2018, 63% of government revenue will come from oil compared with 64% in 2017, despite the fact that oil prices are likely to be higher in 2018 than in 2017, thereby indicating higher contribution from non-oil activities.
- Revenue from tax is expected to be SAR 142 billion in 2018 compared with SAR 97 billion in 2017 budget, mainly boosted by collection of SAR 23 billion from VAT and SAR 28 billion from the expat tax.
- SAR 32 billion (US$9bn) is allocated to Citizens' Accounts, which is a national cash transfer program that was first announced by the Government in December 2016 and opened for registration in February 2017. It aims to increase the efficiency of government benefits and wealth distribution by targeting potentially vulnerable socioeconomic tiers in society. Through targeted government support;

this program is designed to offset any potential negative impact of subsidy reforms and VAT on vulnerable economic segments of society.

- Capital spending is budgeted at SAR 205 billion, however detail of projects for this spending are not available.
- 2018 Budget is likely to be funded by:
  - 50% from oil revenue
  - 30% from non-oil revenue
  - 12% from Debt and
  - 8% from government reserves.
- As at December 2017, SAMA's foreign exchange reserves stood at USD 496 billion, including $332 billion in investment in foreign securities and $101 billion in deposit with foreign banks.

KSA Budget Highlights

	SAR bn	2018 Budget	2017 Budget	2017 Actual	2018 vs 2017 budget
Revenue					
	Oil Revenue	492		440	12%
	Non- oil revenue	291		256	14%
	Total Revenue	**783**	**692**	**696**	**13%**
Expenditure					
	Defense & Security	311		334	0%
	Education	192	228		-16%
	healthcare	147	133		11%
	Cash Transfer program	32			
	Capital Spending	205	181		13%
	Other	91			232%
	Total Expenditure	**978**	**890**	**926**	**10%**
	Deficit	**-195**	**-198**	**-230**	**1%**

Source: Bloomberg, Emirates NBD Research

- In 2017 oil production cuts outweighed the activity gain in the non-oil sector which had negatively been impacted by payment arrears in 2016, leading to economic growth being -0.7%. There is no reliable data available about the outstanding level of government arrears to the private sector. However, most of it is believed to have been paid.

Other Credit Considerations

- The stock of public debt stood at SAR 438bn at the end of 2017. With an additional SAR 117bn of new debt to be issued this year to fund the budget deficit, the stock of public debt would rise to SAR 555bn (20% GDP) by end-2018.
- Privatisation proceeds could also be used to cover a portion of the financing requirement. Aside from the planned Aramco stake sale (where the proceeds have been earmarked for investment by PIF), there are number of other state assets that could be sold to raise additional funds. The economy minister indicated that while assets in the utilities and grains sectors had made significant progress in terms of preparation for privatization, there are other assets in the education, healthcare and transport sectors that could potentially be sold as well.
- KSA made several changes to facilitate privatization of Aramco including a) corporatizing the company structure; b) reducing the tax rate from 85% to 50%; c) revising the royalty payment calculations etc. CEO of Aramco confirmed that the company is ready for an IPO, however timing will depend on getting a go ahead from the government after consideration of market volatility and pricing dynamics. The valuation of Saudi Aramco remains highly uncertain (anywhere between $1tn - $2tn) , but a sale of 5% of its shares would still be the world's largest equity sale. Proceeds from the potential Aramco IPO are not yet factored in rating agencies' projections and once done could result in rating upgrades.
- KSA's Fiscal breakeven oil price is currently around $80/b. Being a member of OPEC, KSA has voluntarily reduced its oil production to below 10m bpd .
- Military spending accounts for one third of the government's total expenditure and is in context of KSA's support for the ruling governments in Yemen and Lebanon against the rebel forces that are believed to be supported by Iran.
- KSA's trade balance is likely to be negatively impacted by cutting of diplomatic ties and trade / transport links with Qatar. That said, exports to Qatar accounted for only 0.8% of KSA's total exports in 2016 (equivalent of $1.4 billion).
- KSA's recent drive to adopt more moderate and modernized Islam may face domestic resistance from the conservative segments of the society, however we see this risk as manageable in view of strong popularity of these measures with the youth.
- The National Transformation Plan (NTP) announced in June 2016, in support of the larger Vision 2030 plan aims to achieve the below:
    - Create 450k new private sector jobs by 2020,
    - Increase female workforce participation to 30% from 22%,
    - Raise home ownership rate to 52% from current 47% by 2020.
    - Balance the government's fiscal budget by 2023 and
    - Privatise some state assets.
- Progress on NTP is being made, however actual quantifiable information is hard to source.

- Monetary policy flexibility is limited given the fixed exchange rate. SAMA is likely to follow the Fed's target rate hikes even though economic growth in the KSA is anemic. Although KSA is unlikely to amend the peg arrangement at a time when political uncertainty is high, the fundamental justification for the peg will gradually erode as its economy makes progress on diversification away from oil. On REER basis, SAR is estimated to be overvalued by more than 30%.

Key Economic Data

	2015	2016	2017e	2018f
Nominal GDP ($bn)	654	646	679	696
GDP growth %	4.1	1.7	-0.4	1.5
CA balance / GDP %	-8.7	-4.3	-1.6	-2.4
Budget balance / GDP %	-6.0	-16.4	-4.8	-3.2
Debt / GDP %	4.1	13.1	17	20
GG Net Debt / GDP %	-121.1	-98.5	-89.1	-82.7
SAMA FX Reserves ($ bn)	616.4	535.8	496.4	

Source: S&P

- Decision making has become more centralized and although more disclosure is being offered about the government finances, transparency on other aspects remain opaque.

Credit Ratings

S&P downgraded its unsolicited rating on KSA from AA- to A+ in 2015 and then to A- in 2016. The last affirmation of the rating at A-/stable was in November 2017 with S&P citing expectations that the Saudi authorities will continue to take steps to consolidate public finances and maintain government liquid assets close to 100% of GDP over the next two years. The next scheduled rating review will be on or before April 6, 2018. Credit ratings could come under pressure if there was any significant increase in domestic or regional political instability as a result of the increasing centralization of power. As per S&P, the ratings on Saudi Arabia are supported by its strong external and fiscal stock positions, which we expect it will maintain despite large central government deficits. The ratings are constrained by weak economic growth, limited public sector transparency, and limited monetary policy flexibility.

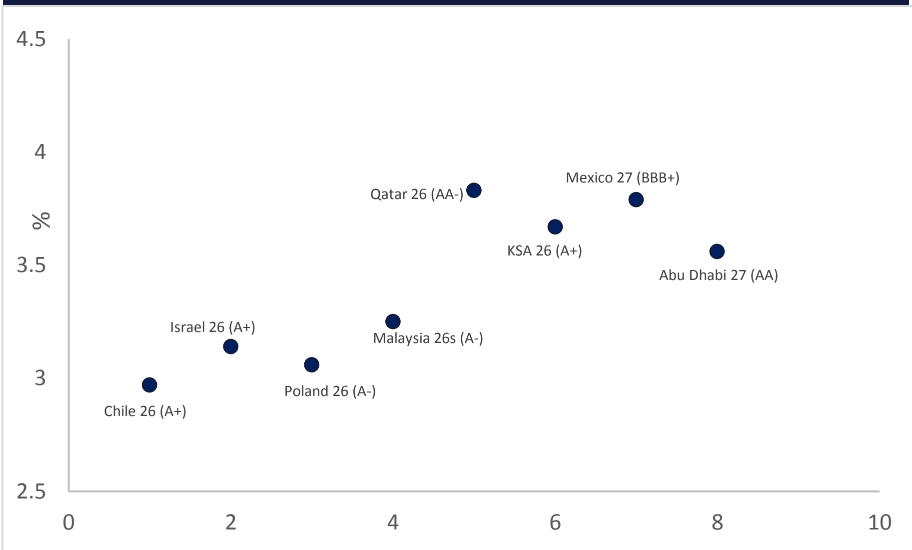
Moody's downgraded KSA's rating from Aa3 to A1 in 2016 and has maintained it at the A1/stable since then. While debt levels are expected to rise, Moody's expect debt repayment requirements to remain below 100% of foreign exchange reserves over the coming years. One of Moody's main concerns is the rigid structure of government spending which is difficult to reduce. Moody's rating incorporates an element of geopolitical risk, driven by regional instability and the country's strategic rivalry with Iran, however any change in exchange rate regime , budget deficit rising over 10% of GDP or increase in debt / GDP to 50% will pressurize the ratings negatively.

Fitch downgraded KSA's rating from AA to A+/stable in 2016 and has left it unchanged since then. Beside strong fiscal and external balance sheet, Fitch's rating gains support from the government's strong commitment to an ambitious reform agenda. In contrast, the rating is constrained by high fiscal deficit and weak governance standard plus subdued business environment. Fitch expects SAMA's FX reserves to decline to 21% of GDP by 2019 from a peak of 58% in 2013 and expects government debt to increase to 25% of GDP by 2019 which will still be below the 'A' category median of 44%. Fitch rates KSA's banking sector at "a" reflecting stable profitability and average Tier 1 capital ratio of 17.2% in mid-2017. Fitch assumes oil at $55/b in 2018.

Relative Value

Despite all the challenges, KSA bonds are likely to retain international investors' interest mainly on relative value basis.

Yield on sovereigns USD bonds (%)



Source: Bloomberg, Emirates NBD Research

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