# SAUDI ARABIA: THINKING OUT OF THE BOX AND RESHAPING THE ECONOMY – PART I

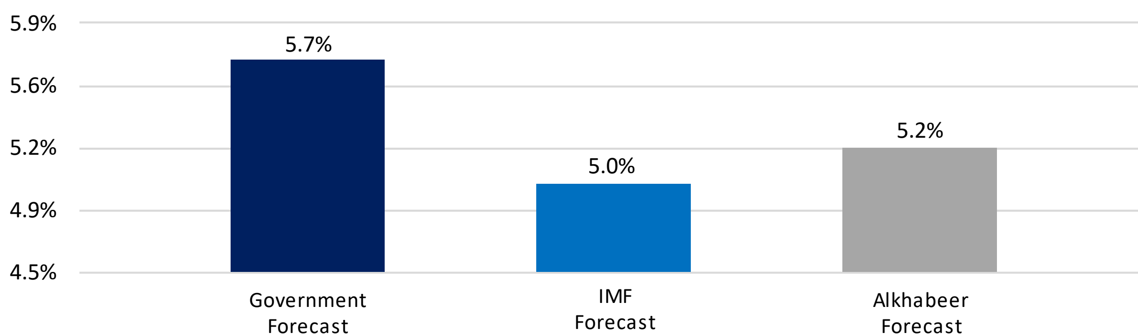
**MAY 2018**

## EXECUTIVE SUMMARY

The oil price decline in the aftermath of the 2008 financial crisis and in late 2015, following the surge in shale oil production in the US and its subsequent adverse repercussions on the Saudi economy, has sensitized the government to reduce the Kingdom's dependence on the oil sector and seek to diversify its sources of income. This has necessitated out of the box thinking on the part of the government by adopting strategies to diversify the economy through the development of the non-oil sector. Several measures and economic reforms have been announced towards achieving this end. It is pertinent to highlight that the Kingdom's strategy of growth through mega investments and social transformation is well supported by reforms at all levels, including the capital markets which are expected to play an important role in implementing the investment plans of the country. With the government focused on guiding the nation's economy away from its oil dependency, we expect the non-oil sector to play a significant role in the growth narrative in the coming years.

There is no doubt that the increase in electricity and fuel prices and the implementation of VAT and various fiscal reforms, are inflationary in the short term. In fact, we expect inflation to rise to over 5.0% this year. Though bitter, in our opinion these are necessary pills to swallow for the nation especially that the government has managed, meanwhile, to limit the near-term negative impact on low-income nationals with a series of measures, including the "Citizens Account Program" and additional payments to state employees, pensioners and soldiers. We believe that the fiscal reforms initiated by the Kingdom will prove positive over the long-term by directing government expenditure to investment rather than consumption.

**Government Reforms Likely to Drive-up Inflation in 2018**




*Source: SAMA, IMF, Alkhabeer Capital*

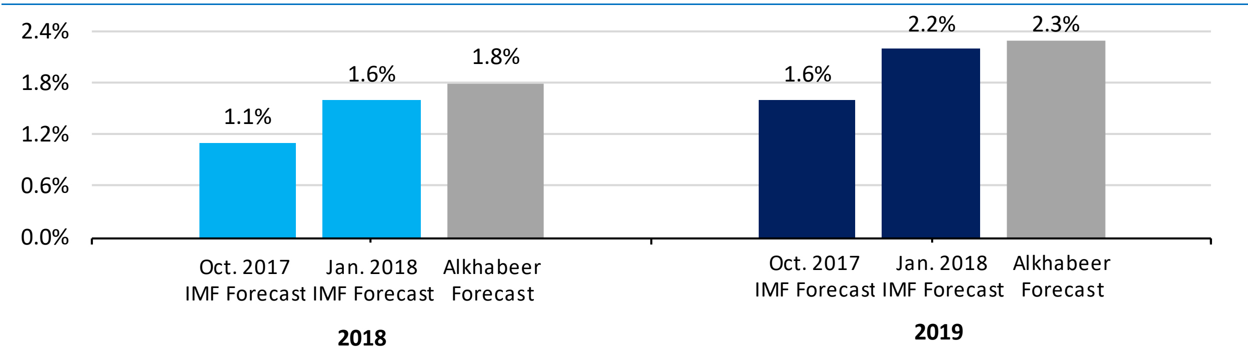
Another leg of the Kingdom's strategy is to improve the skill sets of locals, create more employment opportunities for them and reduce the dependence on expatriates. Changes in the "Nitaqat" system and imposing restrictions on the working of expatriates in a number of job profiles in certain sectors, are geared towards addressing the issue of unemployment among locals. With just over 10.6 million non-Saudi workers against local Saudi jobseekers at about 1.2 million (as of Q3 2017), even a 10% shift over time in employment towards locals, could help solve the unemployment problem. We are optimistic that the nationalization effort and a recovery in the economy will help reduce unemployment among locals significantly over the coming five years. The key challenge for the government and the corporate sector is to provide the proper and necessary training and skill upgradation of locals to enable and accelerate

this transition. In the long-term, the education system is expected to expand to have more schools and colleges that provide vocational courses and training programs, and to witness better education quality to enable locals to be ready for the job market. Regular dialogue with the private sector will help the government to understand and overcome the obstacles faced by businesses in achieving jobs nationalization targets. Among the factors to be reconsidered are the fees levied on expatriates, as it is preferable that the value of these fees vary according to the expatriate's profession and income rather than applying them across the board.

As indicated earlier, the nation's fiscal reforms are geared towards creating flexibility to drive growth in the non-oil sector through partnership with the private sector. There seems to be a sincere recognition that investments in infrastructure projects are important for growth and to create new employment opportunities, and the Kingdom is encouraging investments in mega projects. To appreciate the transformation in perspective, one needs to take cognizance of the large projects under consideration, ranging from the recent agreement with SoftBank to build the world's largest solar plant, to conceptualizing 'NEOM' and the leisure city in Al Qidiya. A key focus of the Kingdom's investment strategy is to develop its tourism and entertainment industries. The various mega development projects have the potential to make the Kingdom a regional tourism and entertainment destination. The decision to overturn the ban on cinemas and the measures taken to encourage the participation of women in the society are not only symbolically significant but will also help create new consumer markets and drive consumer spending.

Support for the Kingdom's effort has come from the recent recovery in oil prices following the OPEC production cut deal, which has enabled it to boost spending to a record level in the 2018 budget. While the IMF has raised its growth forecast for the Saudi economy, we believe that their expectations are conservative. What is important to recognize is that the government is creating a platform for higher growth in the future. Investors focusing only on the short term are likely to miss the bigger picture that is unfolding. In our opinion, if the government is able to manage the short-term adverse impact of fiscal reforms and continues with its investment focused policies, growth will strengthen beyond 2019.

**Saudi Arabia Growth Forecast Revised Higher by the IMF**




*Source: IMF World Economic Outlook, January 2018, Alkhabeer Capital*

The recent increase in oil prices has also eased the near-term pressure on the fiscal. With current oil prices significantly higher than prices assumed in the preparation of the Saudi budget (estimated to be about $53 a barrel), the pressure on fiscal will be lower. The increase in government expenditure, which is slated to reach over SAR 1 trillion this year, including the additional investment from the PIF and the National Development Funds - is positive for the economy in the near term. We believe that the production

discipline adhered to by the OPEC will continue to support oil prices this year, even as the growth in the US shale oil output limits any sharp rise in prices.

The Kingdom also recognizes that a robust capital market is essential to attract foreign investments, and its efforts have borne fruit with the FTSE Russel deciding to include Saudi Arabia in its emerging equity index beginning March 2019. The Kingdom would be the largest component of the index within the Middle East, with an overall weighting of around 2.7%. Initial estimates indicate that this could result in inflows of over SAR 15 billion. The development also makes the case for Saudi Arabia's inclusion in the MSCI index stronger, which is anticipated to result in inflows of more than SAR 75 billion. The listing of Saudi Aramco could change the dynamics of the local market and give the Kingdom a shot-in-the-arm to move forward with its privatization drive. This would also necessitate an increase the Kingdom's weighting in the FTSE index to over 4.5% and its potential 2.4% weightage in the MSCI Emerging Markets index to 4.0%, resulting in higher inflows. If active investors also increase their Saudi exposure in line with these weightings, total inflows into Saudi markets could reach SAR 250 billion. Considering Aramco's issue size, participation by foreign investors will be the key to success, supporting the country's initiatives geared towards boosting foreign investments in the Kingdom. The NOMU market is expected to pick up pace once investments in large projects start kicking in and order and business flows start picking up for SMEs. The development of such markets takes time – what is important is that a serious beginning has been made and a structure is in place to support investments, both for large corporates as well as for SMEs. Meanwhile, despite some hiccups witnessed lately, the REIT sector remains attractive, given the long-term investment opportunities in real estate. We believe that the various mega projects will drive demand for the real estate sector going forward and a healthy REIT market will help channelize investments in the sector.

The Kingdom has made an effort in thinking out of the box to develop strategies that are required for the long-term sustainable growth of the economy, while at the same time addressing the short-term impact of the reforms necessary to diversify the source of income. With the progressive policies of the Kingdom, we expect the reforms process to continue and growth to pick-up pace. The key sectors that should be on investors' radar are construction, retail, entertainment, education, healthcare and tourism. While there is no doubt that there are challenges ahead, we are optimistic that the changes being ushered in will open a brighter future for Saudi Arabia.

Governments and policymakers need to periodically review the direction and performance of economies and assess the need to make required changes to ensure achievement of economic objectives. Failure to do so is likely to impede growth and development and make an economy vulnerable to shocks. It is, therefore, imperative for economies to assess their progress and make necessary improvements to avoid adverse shocks. Saudi Arabia is currently in the midst of one such change, which has necessitated a relook at its existing economic model to pursue new goals and initiatives which will stimulate long-term growth. Diversification of the economy away from its current high dependence on oil is a necessity in the current global environment, where alternative sources are likely to take a higher share of the energy market over the coming decade.

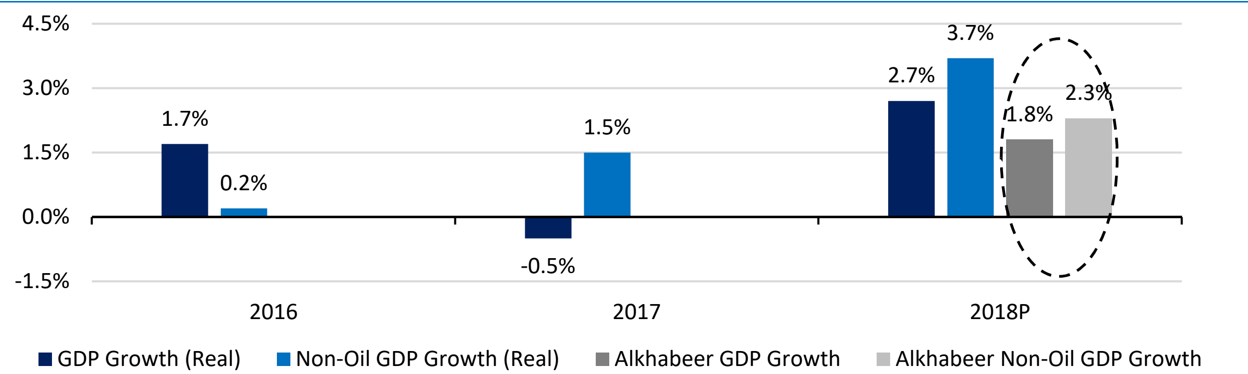
## The Year of Transformation

2017 was an eventful year for the Kingdom on the economic front, with the government taking several key steps towards its goal of reducing dependence on oil and reforming the Saudi economy and society. Chief among them were presenting the largest budget in the nation's history, and implementing tax reforms, such as the introduction of sin tax on harmful goods. Large projects are also in the pipeline to develop areas dedicated to tourism and entertainment. These initiatives could lead to the development of a large tourism and entertainment industry over the next decade. The government is also cognizant of the high levels of youth unemployment and steps have been taken to address the issue through levies on expats and nationalization of jobs across the board. The introduction of Value Added Tax (VAT) and reduction in subsidies will further propel the Kingdom towards achieving its Vision 2030 goals. However, there will be negative impact of these levies and taxes on businesses and consumers. We discuss below some key issues of economic importance and chart out the outlook for the economy in 2018.

**Saudi Economy: Challenges to Continue in 2018, Even as Growth Expected to Improve**

The non-oil sector in Saudi Arabia grew 1.5% in 2017, driven by growth in the manufacturing and services sectors. However, the oil sector contracted in 2017 following strategic output cuts carried out in the sector in the interest of long-term price stability. On the balance, this drop outweighed the faster growing non-oil sector and the GDP contracted by 0.5% in 2017, according to the Ministry of Economy and Planning (MEP).

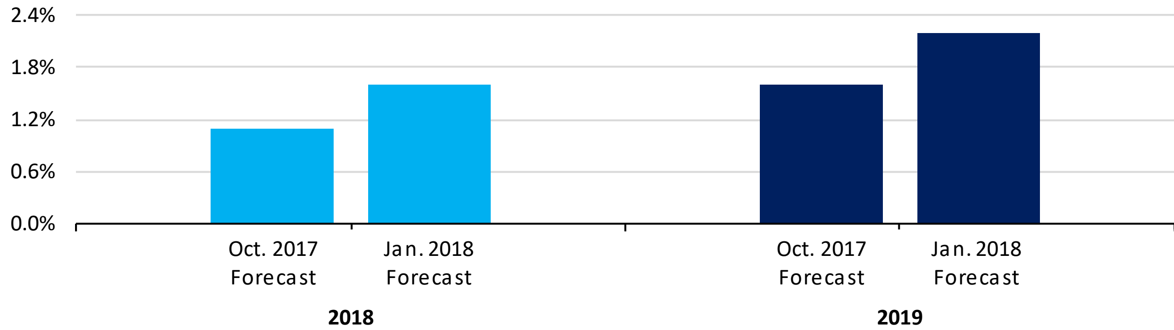
**Saudi GDP Growth**




*Source: Ministry of Finance, Alkhabeer Capital*

Stable to relatively higher oil prices, higher government spending and expansion of the non-oil sector will be the key drivers of growth in 2018. The government expects the economy to rebound in 2018 and grow by 2.7%, on the back of a 3.7% increase in non-oil GDP, more than twice the rate in 2017. Government handouts and a cash transfer program aimed at easing the burden of VAT and subsidy cuts on citizens, is expected to encourage consumer spending and boost non-oil growth. The oil sector is also expected to return to growth, following the contraction in 2017, driven by increased demand.

**Saudi Arabia's Growth Forecast Revised Higher by the IMF**

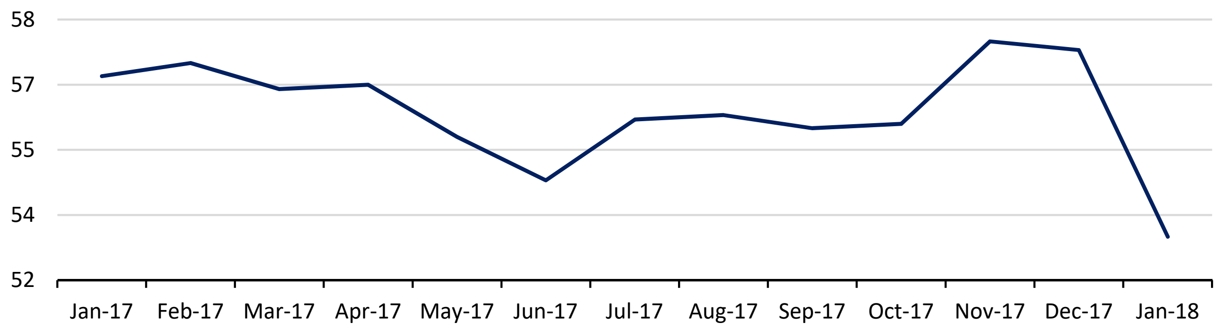



Source: IMF World Economic Outlook, January 2018

Meanwhile, the IMF, in its January 2018 update to the World Economic Outlook report, forecast that the Saudi economy will grow by 1.6% in 2018 and by 2.2% in 2019, higher than its earlier forecasts, driven by a "recovery in domestic demand," on the back of improved oil prices. Although the IMF raised its growth forecast for the Saudi economy, it continued to remain conservative in its assessment, highlighting that the government's fiscal adjustments would weigh on GDP growth in the short term.

We expect the Saudi economy to grow faster than what the IMF expects, although the government's estimate of 2.7% growth seems a little optimistic. Reforms to boost non-oil sector growth pose a significant challenge for the government, as energy reforms and expat levies will increase costs for private companies and VAT could negatively impact consumer spending in the near term. In our view, the various stimulus packages announced by the government would not be able to fully offset the impact of fiscal reforms, particularly for those working in the private sector and expatriates, thereby hampering non-oil sector growth in the short term, which we still expect to be around 2.3% in 2018. However, we believe that government initiatives to boost the non-oil sector will gradually begin to seep into the economy. We also expect oil-GDP to rebound from a contraction in 2017 to expand in 2018, as the Kingdom will benefit from increased global demand, amid the rise and stability in oil prices, resulting in overall GDP growth of about 1.8% in 2018.

**Softening in Demand Resulted in the Decline in Non-Oil Sector PMI in January 2018**

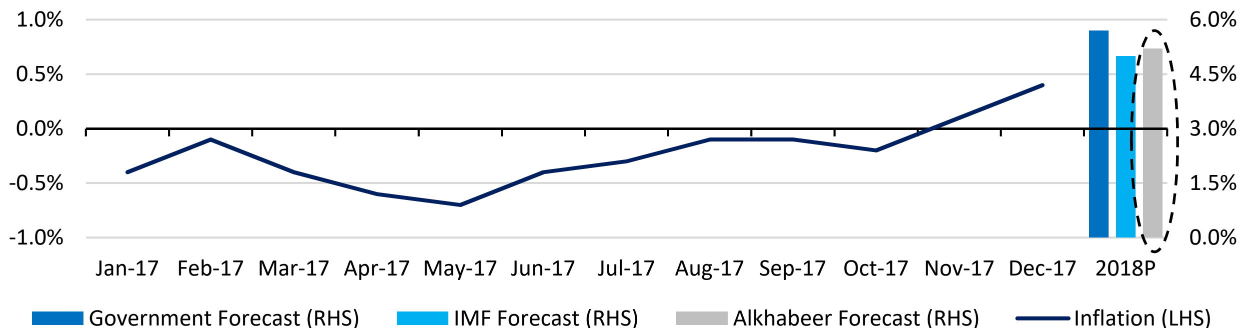



*Source: Bloomberg*

Non-oil private sector PMI indicated expansion throughout 2017 and stood at 57.3 in December, buoyed by strong increases in both output and new orders. Business activity picked-up during the last quarter of 2017 as consumer demand for goods rose ahead of the introduction of VAT at the beginning of 2018. The government also boosted spending to SAR 354 billion during the fourth quarter, accounting for about 38% of all spending for 2017. However, growth in the non-oil economy slowed down in January 2018, with the PMI dropping to 53.0, as demand softened following the introduction of VAT, resulting in weaker business activity and new order growth. Businesses also witnessed an increase in input costs as the VAT and fuel subsidy cuts came into effect in January 2018.

Inflation, which remained in negative territory for most of 2017 amid weak demand, on the back of the government's measures and volatile oil prices, rose to 0.4% in December 2017. Inflation had shown signs of improvement since the middle of 2017, following a spate of measures announced by the government, primarily the imposition of selective taxes on tobacco products, energy drinks and soft drinks in June 2017.

**Government Reforms Likely to Drive-up Inflation in 2018**




*Source: SAMA, Alkhabeer Capital*

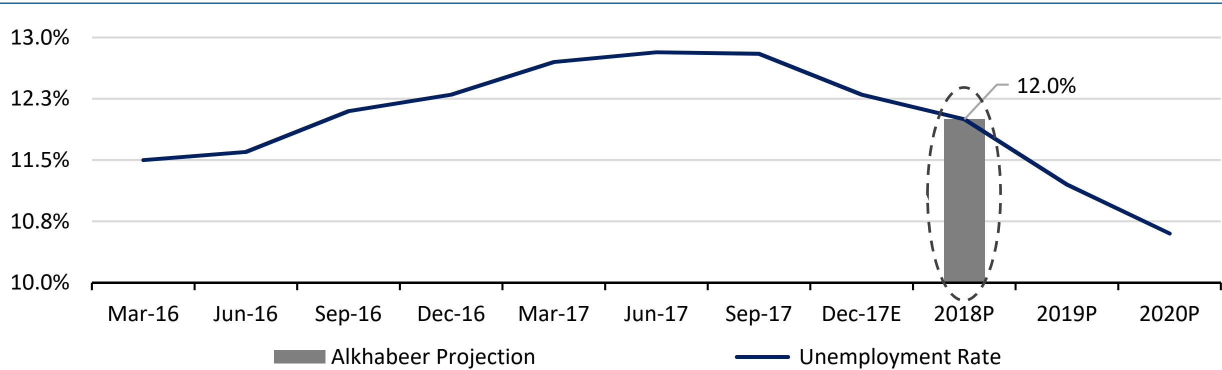
The government expects inflation to jump to 5.7% in 2018, on the back of energy and water subsidy cuts, gasoline price hike and the proposed taxes. On similar lines, the IMF has also projected inflationary pressures in Saudi Arabia to increase going forward and inflation to reach closer to 5%. A sharp increase in consumer prices could adversely affect the purchasing power of people forcing many low-to-middle-

income households to tighten their purse strings. Additionally, the projected spike in consumer prices will impact foreign workers more than locals, as the latter will be compensated by government handouts.

We expect inflation to pick up pace and rise to over 5.0% in 2018, largely driven by the impact of VAT, the fuel price hike and the rise in electricity tariffs. However, we expect inflation to moderate thereafter, in 2019, as the effect of VAT subsides gradually. Although the decision to reduce energy subsidies and implement VAT will escalate costs for both consumers and businesses in the short-term, we believe that these strategic measures will prove very positive over the long-term by directing government expenditure to investment rather than consumption.

A key aspect that the government is keen to correct is the high unemployment among locals. The Ministry of Labor and Social Development amended its existing Nitaqat system for organizations in 2017 by increasing the mandatory employment ratio of Saudi nationals to expatriate employees. The amended system will incentivize private sector organizations based on their efforts in employing Saudi nationals. The number of Saudi citizens entering the jobs market climbed in the latter half of 2017 after the government launched five new programs to increase local employment in October. Over 84,000 locals enrolled in the labor market in October and November alone, as the government enforced nationalization of many jobs and roped in various private sector players to offer job opportunities for young Saudis.

**Unemployment Rate Expected to Fall in Response to Government Initiatives**



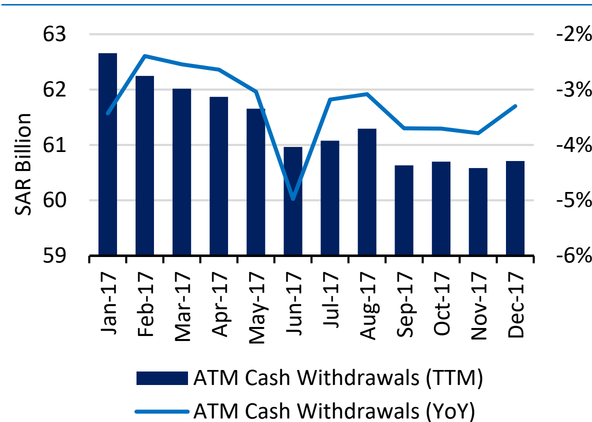

*Source: Bloomberg, Ministry of Finance Forecasts, Alkhabeer Capital*

The Saudi Arabian Monetary Authority's (SAMA) mandate that all insurance companies must nationalize jobs related to sale or marketing of insurance products to individuals by 1st February 2018 will further boost the jobs nationalization program. Additionally, the Kingdom's decision to restrict expats from working in twelve sectors, mostly in retail and sales profiles, will further enhance employment opportunities for locals. Moreover, easing of social restrictions for women will open up employment opportunities and boost their participation in the workforce. We expect that the government's efforts to nationalize jobs and levying of fee on expats, geared towards raising employment opportunities for locals, will help bring down the unemployment rate in the Kingdom to about 12.0% in 2018, in line with the MEP forecast.

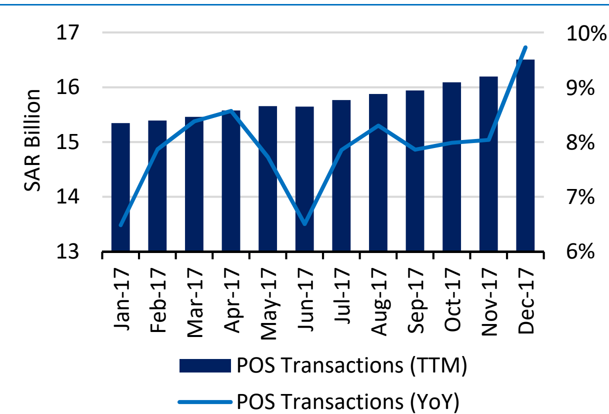
On the consumer front, point-of-sale (POS) transactions, on a trailing-twelve-month basis, have witnessed growth since 2016, while cash withdrawals have seen a considerable decline over the period. The consumer goods market experienced a surge in activity in the latter half of 2017, as consumers went on a

shopping spree before the implementation of VAT and other levies in early 2018. The government's decision to reinstate allowances and perks for civil servants and military staff in April 2017 which were cut in September 2016, along with the later decisions to give additional monthly payments to state employees and bonuses to pensioners and soldiers, and the "Citizens Account Program, will boost domestic demand in 2018. The government's initiatives to nationalize jobs will further boost consumer spending. On the flipside, the inflationary nature of fiscal reforms will put a squeeze on disposable incomes for many households and impede spending, at least in the short-term. We believe that VAT, energy subsidy reductions and fuel price hikes are a positive for the economy in the long-term and consumer spending will gradually pick-up pace.

**Trends in ATM Withdrawals**



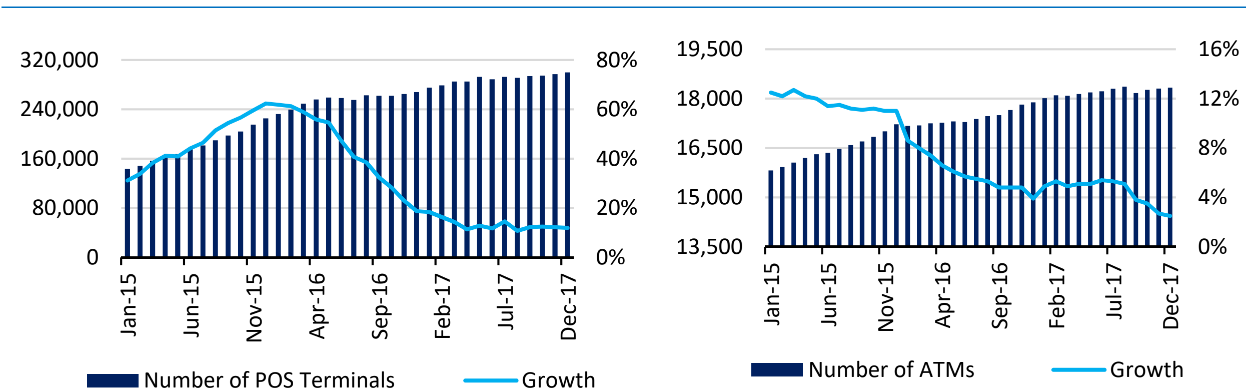

**POS Transactions**




*Source: SAMA*

The rising trend in POS transactions of late can be attributed to the Kingdom's inclination towards the use of technology which has resulted in cards being increasingly preferred to cash as a mode of transaction. Significant growth was witnessed in the deployment of POS terminals by Saudi banks during 2015 and 2016, while ATM deployment growth has been nearly flat over the last few years.

**Number of POS Terminals Expanded Rapidly in 2015 and 2016**




*Source: SAMA*

POS transactions growth has been driven by sectors such as food & beverage, clothing & footwear and restaurants & hotels - sectors which attract high spending per visit - thereby substantiating increased POS usage against cash transactions. We expect Saudi consumers to increasingly embrace cashless modes of transactions, including the use of online payments going forward.

We believe that the reform process set in motion by the Saudi government in 2017 will continue in 2018 and beyond. We expect that the gradual easing in social and economic restrictions will expand the domestic market for tourism, entertainment and consumer items and will have a positive rub-off effect on economic growth over the coming years.

**NTP 2020: Government Actions Indicate Strong Resolve to Boost Non-Oil Revenues; However Near-Term Challenges for Small and Medium Businesses Have Increased**

The 'Saudi National Transformation Program' (NTP) was redrafted in September 2017 to better suit the ever-changing economic, demographic and technological needs. Notwithstanding the changes, the focus continues to remain on growing the non-oil economy aggressively through initiatives in tourism, taxation and localization. We will discuss Tourism as part of our discussion on Social Reforms in a later section.

2017 saw progress towards achieving the government's goal of reducing dependence on oil revenues through various measures, which included imposition of 100% tax on tobacco products and energy drinks and a 50% tax on soft drinks in the middle of 2017. This resulted in additional tax revenue of approximately SAR 7.5 billion in the second half of the year. The new year 2018 heralded a long overdue hike in electricity tariffs and gasoline prices, along with the introduction of VAT. Gasoline prices are up over 80% for Octane-91 and over 125% for Octane-95, while electricity tariff has been raised for residential, commercial, agricultural, healthcare, private education and charitable institutions. Residential consumers have been hit worst by the electricity tariff hike, with tariffs for an average household set to increase about threefold. Diesel and kerosene were spared price hikes, considering their usage in industrial applications and commercial transportation. These decisions display the government resolve to reduce subsidies and better align the expenditure mix to support growth in the non-oil sector. We expect such additional levies and measures to further boost non-oil revenue going forward. The government has also introduced a fee to be levied on expatriates working in the private sector and their dependents. The SAR 100 monthly levy on each dependent that an expat sponsors came into effect in July 2017 and is set to rise gradually to SAR 400 by July 2020. Similarly, a monthly expat levy, introduced in January 2018 and to be paid by private sector companies, currently stands at SAR 400 for companies employing more foreign nationals than Saudi nationals and SAR 300 for companies employing more Saudi nationals and will rise gradually to SAR 800 and SAR 700, respectively, by 2020. The government expects to generate more than SAR 130 billion during the 2018-2020 period from these levies. According to the General Authority for Statistics, there are over 94,000 expat workers who left the nation during the July-September 2017 period. Further, as part of a nationwide crackdown against violators of residency and labor regulations, authorities have arrested 337,281 foreigners, most of them without residence or work permits, since November 2017.

While the steps to cut energy subsidy and introduce levies on expats will boost government finances, one needs to be cognizant of the near-term risks of these measures for businesses. Profit margins for many businesses, especially SMEs, are being adversely impacted as costs rise, and they are unable to pass on the full cost increase. Companies could face difficulties adhering to the requirements of nationalizing jobs, as local Saudi graduates are likely to demand higher salaries compared to migrant workers. Employers will find it challenging to replace competent and experienced expats with locals of similar competence, at

comparable salaries. Alternatively, if companies hire locals without comparable experience, they would need to spend on training. In either case, corporates would experience an increase in costs and a pressure on their margins. Large enterprises are exploring possibilities of shifting their operations partially from the Kingdom to neighboring countries to reduce costs.

With the cost of living rising for expats, including the new levies, they are likely to demand higher salaries. Moreover, the dependent levy, to be paid in lump-sum at the time of visa / resident permit application or renewal for the expected duration of the dependents' stay, could be a burden on expatriates, and many might prefer to send their family members back home. This could result in higher remittances and less spending within the Kingdom, dampening the government's projected revenue forecasts. This could also have an adverse impact on the nation's housing sector. The expat levies could eventually force many working expatriates to leave the Kingdom and despite the government's efforts to increase local participation in the workforce, the country could face a shortage of experienced and expert personnel over the next few years. We believe that the government needs to balance its effort of boosting local employment without unduly impacting businesses. In our view, nationalization of jobs that require experienced workers and high level of skillsets could be delayed until Saudis are trained by expats to ensure a smooth transition without compromising on the quality of work. For jobs that require relatively lower skillsets, the government could look to develop the skills of Saudi workers by providing them with the necessary training. Regular dialogue with the private sector will help the government to understand and overcome the obstacles faced by businesses in achieving nationalization targets. In the long-term, reforming of the education system and introduction of vocational courses and training programs in schools and colleges will enable locals to be ready for the job market.

VAT was implemented across the nation from 1st January 2018, with the 5% tax imposed on food, clothes, fuel, entertainment, electronics, telephone, water and electricity bills and is expected to add an estimated SAR 35 billion to the government's coffers in 2018. The government plans to spend the additional revenue on infrastructure and development works. With the introduction of VAT, there is uncertainty right now within corporates on how the impact will play out. A rise in December 2017 sales for many retailers and a subsequent slowdown in January, largely driven by consumers seeking to take advantage of pre-VAT prices, has only added to their predicament. We expect the introduction of VAT and the increase in fuel prices to lead to higher consumer prices that could possibly affect private consumption in the short term and in our opinion, businesses will take a couple of quarters to adjust to the new system. However, the introduction of VAT is a prudent step in the government's initiative to reduce dependence on oil. If the global economic growth remains robust and oil prices continue to rise steadily, the adverse impact of VAT on demand could be momentary. If oil prices remain buoyed, as they are currently, VAT implementation in Saudi Arabia should progress smoothly, as the government will have greater flexibility to cushion the adverse impact. Even if there are some short-term hiccups due to the implementation of the new VAT regime, we remain cautiously positive that this step will go a long way in diversifying the Saudi economy away from its dependence on oil.

The removal of subsidies and the sharp increase in prices of utilities and fuels has the potential to affect the low and middle-income Saudi households adversely. The Kingdom, accordingly, announced a slew of steps to cushion the impact on such households and to reduce unemployment among local youth. Chief among these were the Citizens Account program and the nationalization of jobs program which we have discussed earlier. The Citizens Account Program, a cash transfer program targeted to help low and middle-income Saudi households cope with increased costs, was approved in December 2017, with SAR 30 billion

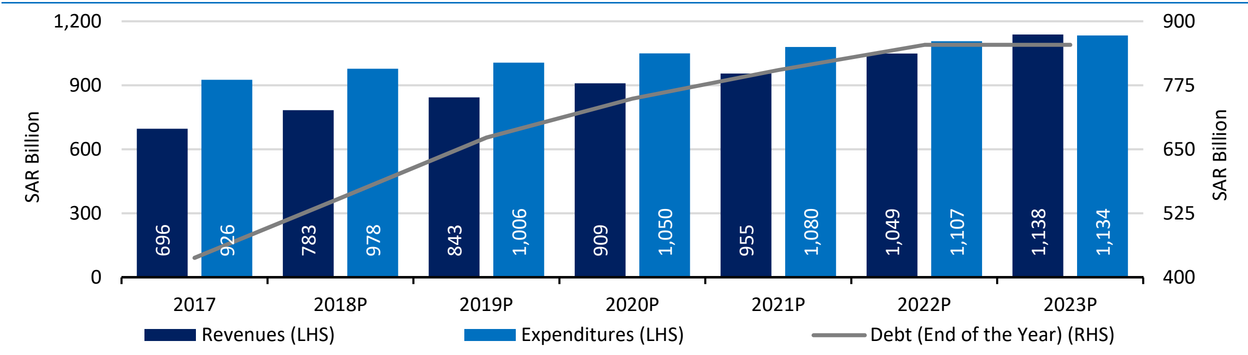
set to be spent by the government in 2018 as part of this program. In February 2018, the government made the third payment of SAR 2.2 billion towards the Citizens Account, increasing the total amount deposited in the account to over SAR 6 billion till date. Around 46% of eligible households and individuals received about SAR 934 on average per family in the third installment, and a total of about 11.6 million individuals, families and their dependents have benefitted from the Program since its inception in late 2017. Additionally, the government plans to spend about SAR 50 billion in 2018 to cover the increased cost of living for citizens from the fuel price hike and VAT, with a monthly payment of SAR 1,000 to state employees and SAR 5,000 in bonuses to pensioners and soldiers.

Our view is that the Citizens Account program and efforts to nationalize jobs will go a long way towards encouraging consumer spending and boosting local participation in the economy. However, the government needs to tread cautiously and ensure that businesses do not face disruption and severe margin pressures. We believe that a more prudent implementation of the jobs nationalization program will have a positive impact on employment and also on the overall economy in the long-term.

**The 2018 Budget: Tax Reforms to Drive Revenue, Government Spending to Provide a Boost to Growth**

The last couple of years have been tough for Saudi fiscal, as weakness in oil prices affected growth and government revenues, leading to a sharp increase in the fiscal deficit. The resulting austerity measures resulted in an economic contraction in 2017. However, with the recent recovery in oil prices and effective measures to raise non-oil revenues, the government decided to reverse pubic austerity measures in its recent budget, raising spending to the highest ever. On the revenue side, the budget is reform focused, while care has been taken to cushion the negative impact of reforms through higher expenditure and support to low and middle-income groups. We expect the expansionary budget, with a strong focus on diversifying the revenue base, to bolster economic growth in 2018 and beyond.

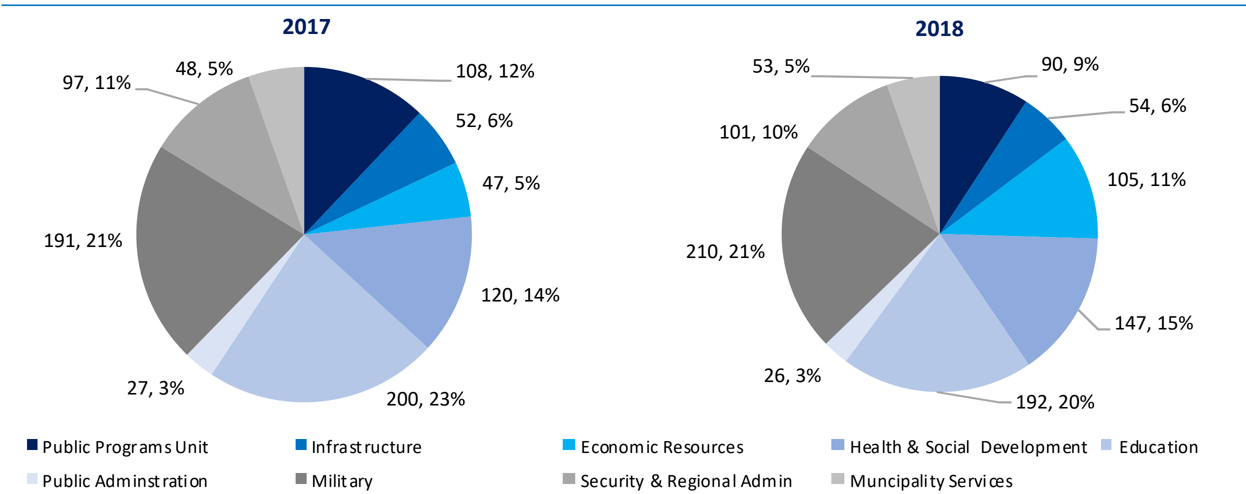
**Saudi Revenue and Expenditure**




*Source: Ministry of Finance*

Revenue for 2018 is achievable, in our view, given the expected stability in oil prices and the increase in non-oil revenue. However, a shortfall in projected revenue cannot be ruled out, especially if the government's tax collection target from the levies imposed on expatriates is not met. The increase in total expenditure, which is slated to reach over SAR 1 trillion, including the additional state investment expenditure of around SAR 133 billion - SAR 83 billion from the Public Investment Fund (PIF) and SAR 50 billion from the National Development Funds - is a big positive for the economy.

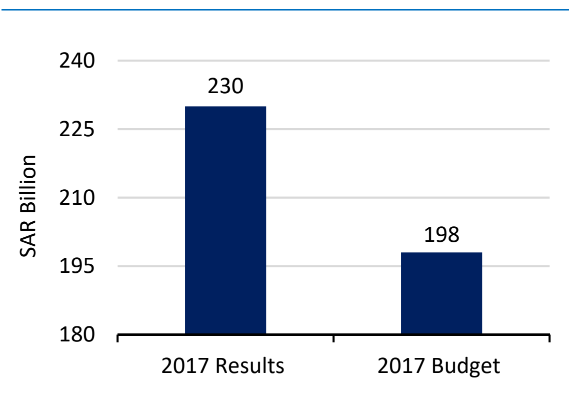
**2017 vs. 2018 Budget (SAR Billion, % Composition)**




*Source: Ministry of Finance*

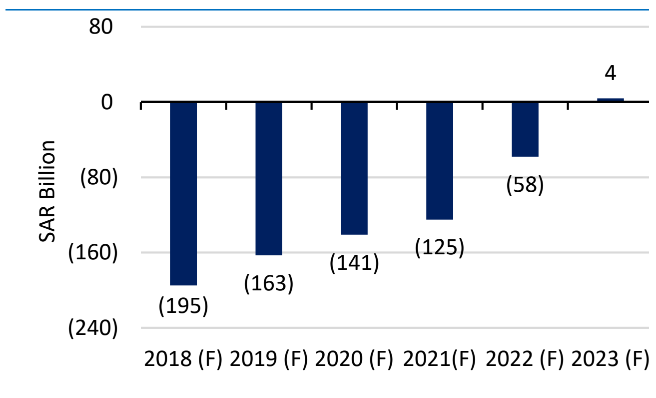
Military spending, at 21% of total expenditure, or SAR 210 billion, has edged out education spending, at 19.6% of total expenditure, or SAR 192 billion, for the first time since the government began revealing its spending on defense in 2016. This is understandable considering that the security needs of the nation are paramount. Among the large expenditure heads, spending on education is lower than 2017, as the focus in 2018 is on cushioning the impact of tax increases on the economy. Capital expenditure is projected to increase 14.0% from 2017 to stand close to 13.5% of the nation's GDP. It includes allocations for housing and various development sectors, which would help contribute to economic growth and employment opportunities.

**Estimated vs Actual Deficit in 2017**




*Source: Ministry of Finance*

**(Deficit) / Surplus**



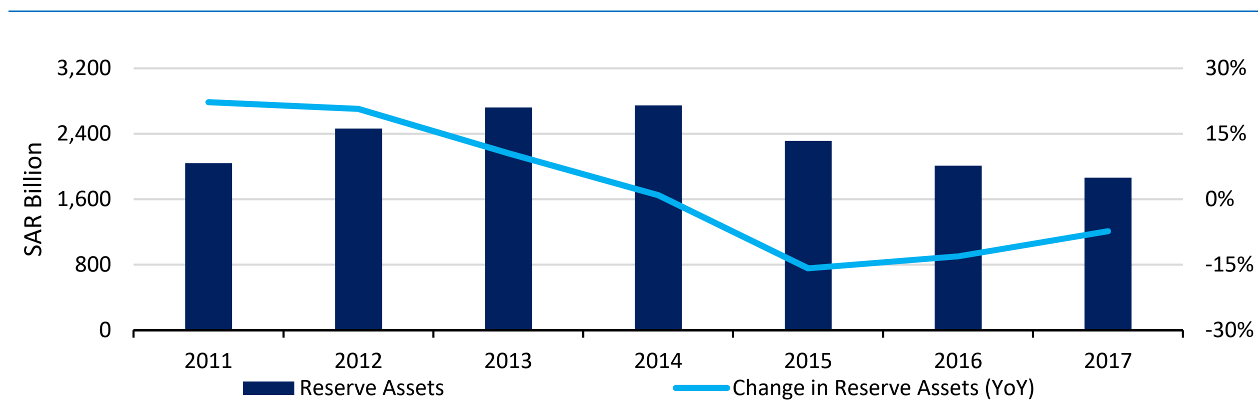

*Source: Ministry of Finance*

The government expects budget deficit for 2018 to be SAR 195 billion or 7.3% of GDP, lower than the estimated 8.9% of GDP in 2017 and sharply below the 12.8% of GDP in 2016. In 2017, the Saudi government, through four monthly Riyal denominated sukuk issuances between July and October, raised SAR 47 billion, to enable it to address its budget deficit. In total, the government funded the actual deficit of SAR 230 billion (16% higher than budgeted) by raising SAR 134 billion through debt and SAR 78 billion from internal sources and reserves in 2017. For 2018, the government plans to fund the budgeted deficit

of SAR 195 billion through SAR 117 billion of borrowings and about SAR 78 billion from its reserves. The government's expansionary path is set to result in near doubling of its debt from 2017 through 2023 and set back its target of achieving budget surplus from the year 2020 to 2023. We expect global liquidity to remain easy through 2018 and see little challenge in funding the budget deficit in 2018.

Strained finances due to the oil price decline since 2014 forced the government to draw-down on its reserves to fund its large fiscal deficits. However, the government's austerity measures, the pick-up in oil prices and increased tax revenues following the introduction of sin-tax in mid-2017, along with the issuance of debt in the form of Riyal denominated sukuks, resulted in the pace of decline in reserves to slow-down significantly in 2017 from 2016.

**Decline in Saudi Reserve Assets Slowed-down in 2017**




*Source: SAMA*

Going forward, reserves are expected to decline further, as the government will draw-down on them to meet its spending targets. In our view, the government will continue to spend more than what it has budgeted in order to boost non-oil revenues and bring the Kingdom back to its growth path. Additional, government spending to mitigate the impact of increased fuel prices and subsidy cuts on citizens will further burden the exchequer. We believe there is a real risk that the government will over-run its budget deficit target for 2018.

**Oil: We Expect Prices to Remain Buoyed Through 2018**

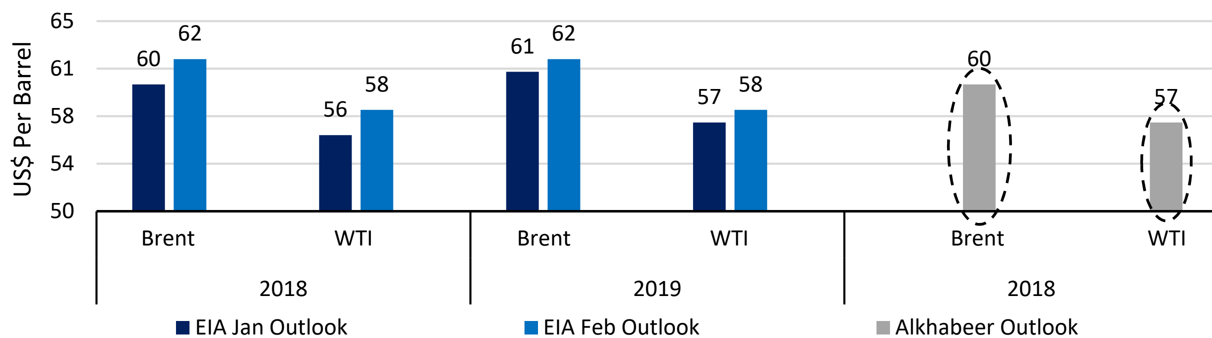
Oil markets witnessed a seismic shift in 2017, after OPEC, Russia and other major oil producing countries agreed to production cuts that will extend through 2018, resulting in declining inventories and steadily rising prices, thereby marking an end to oil-market oversupply that lasted nearly three years. In January 2018, spot prices for Brent crude averaged $69 per barrel, an increase of about $5 per barrel from its December 2017 level, as oil inventories, both in the US and globally, fell steadily. Monthly Brent prices, on average, have increased for seven consecutive months and in January 2018, spot prices moved above $70 per barrel for the first time since December 2014.

**Brent Crude Oil Futures**

*Source: Bloomberg*

The Energy Information Administration "EIA", in its February 2018 Short-Term Energy Outlook report, raised its forecast for crude oil prices by $2 per barrel to $62 per barrel for Brent and $58 per barrel for WTI from its January 2018 outlook. The agency expects WTI crude oil prices to average $4 per barrel lower than Brent prices in both 2018 and 2019.

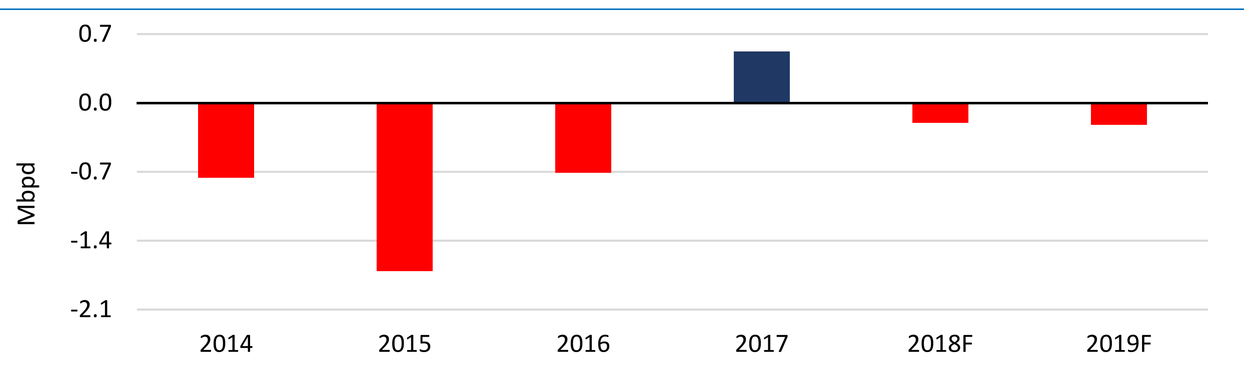
**EIA Upgraded its Outlook for Oil in February 2018**




*Source: EIA Short-Term Energy Outlook Report, January and February 2018, Alkhabeer Capital*

2017 witnessed a reversal in the demand-supply balance led by OPEC's production cut agreement. The compliance with agreed output reduction targets across all participating OPEC and non-OPEC countries stood at 107% in 2017. However, the EIA expects demand to increase at a slower pace compared to supply going forward - it expects the increased production levels in Libya towards the end of 2017 to continue into 2018 and overall OPEC production to return to pre-agreement levels by 2019.

**Trend in Global Demand-Supply Balance Reversed in 2017**



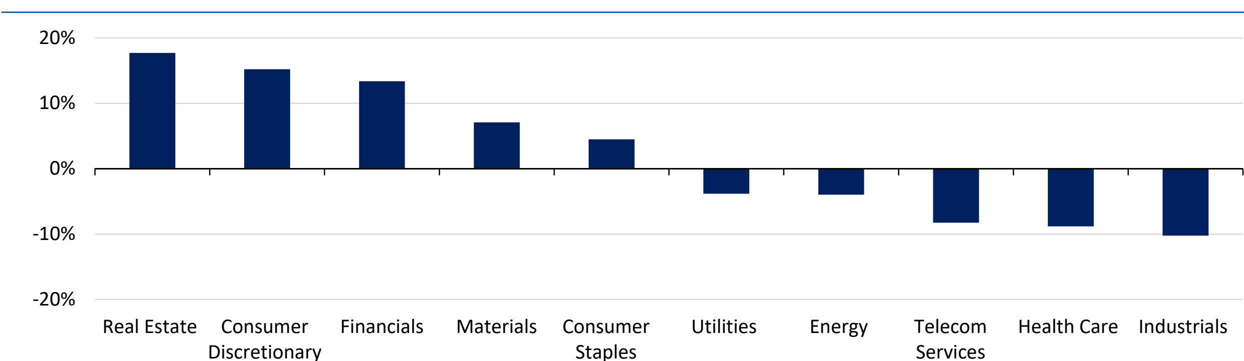

*Source: EIA Short-Term Energy Outlook Report, February 2018*

Improved global economic growth is expected to support oil prices going forward, especially in the light of the IMF's recent upgrade of its global growth forecast to 3.9% for both 2018 and 2019, 0.2 percentage points higher than its October 2017 forecast. Suggestions by several oil ministers following the January 2018 OPEC monitoring committee meeting that the production cut agreement could be extended in some form beyond the current expiration at the end of 2018, could further support oil prices in 2018. In January 2018, compliance towards production cuts stood at 133%. However, continued growth in the US shale oil output could put a ceiling on oil prices and we may not see substantial gains. Additionally, the US Federal Reserve's hawkish stance on monetary policy is likely to keep the US Dollar buoyed in 2018, thereby negatively impacting oil prices. We expect the crude oil market to remain volatile through 2018, and average about $60 per barrel.

**Capital Markets: Reforms Take Shape as REITs Begin to Gain Traction**

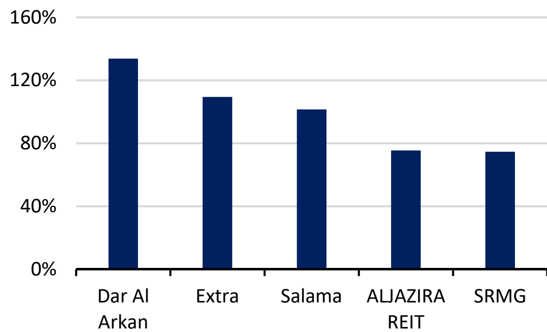
The Tadawul All Share Index gained a mere 0.2% during 2017, amid political and economic uncertainty and the continued impact of low oil prices. We are cautiously positive going into 2018. We expect supply discipline in the oil market to be maintained and the reform process to continue supporting the markets, although geopolitical tensions in the region could lead to volatility and capping of returns.

**Tadawul Total Sectoral Returns – 2017**



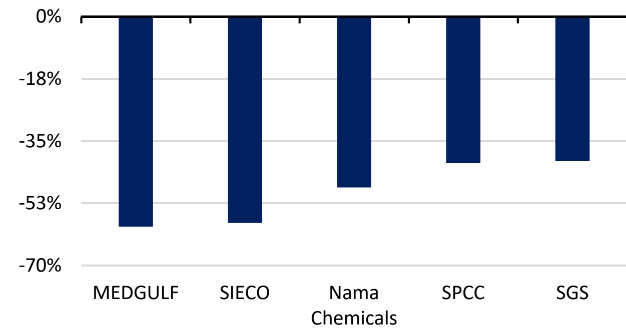

*Source: Bloomberg*

**Top Market Gainers - 2017**




*Source: Tadawul*

**Top Market Losers - 2017**




*Source: Tadawul*

Saudi Arabia was added to the MSCI Emerging Markets watch list in 2017, in preparation for its inclusion in the MSCI index for Emerging Markets, in light of several capital market reforms over the last few years, including easing restrictions on foreign investments and new corporate governance rules, among others. The easing in foreign investment rules resulted in the number of qualified foreign institutions in Saudi Arabia to more than double to over 120 in 2017 from 2016. The Kingdom's anti-corruption drive is expected to result in better overall transparency going forward and will go a long way in boosting investor confidence in the Saudi markets and further draw foreign investors to its shores. The possible inclusion of 32 major Saudi stocks in the index in the foreseeable future could give the country a potential weight of 2.3% in the index. Morgan Stanley Capital expects higher weight of the Kingdom in the index in case of a listing of Saudi Aramco on Tadawul, with the inclusion of ARAMCO in the index. Morgan Stanley's decision will be announced in June 2018, and the potential upgrade will be made over two phases in May 2019 and August 2019. Estimates indicate that the upgrade could result in inflows of about SAR 140 billion, taking into account the size of active and inactive funds following the index which is estimated at SAR 6 trillion. Meanwhile, in a recent announcement, FTSE Russel decided to include Saudi Arabia in its emerging equity index over phases beginning March 2019 and ending December 2019. The Kingdom would be the largest component of the index within the Middle East, with an overall weighting of 2.7%. The weighting would increase to over 4.6% in case of a listing of Saudi Aramco on Tadawul. It is expected that this could result in inflows of over SAR 20 billion, taking into consideration the size of inactive funds following the index which is estimated at SAR 750 billion.

At the beginning of 2018, Tadawul announced additional market reforms, including the introduction of a market-making program and steps to allow asset managers to aggregate orders. Further reforms expected to be undertaken soon, such as setting-up of a clearing house to enable derivatives trading later in 2019 and a plan to cross-list stocks with other Gulf and international exchanges, will gear the nation towards winning emerging market status.

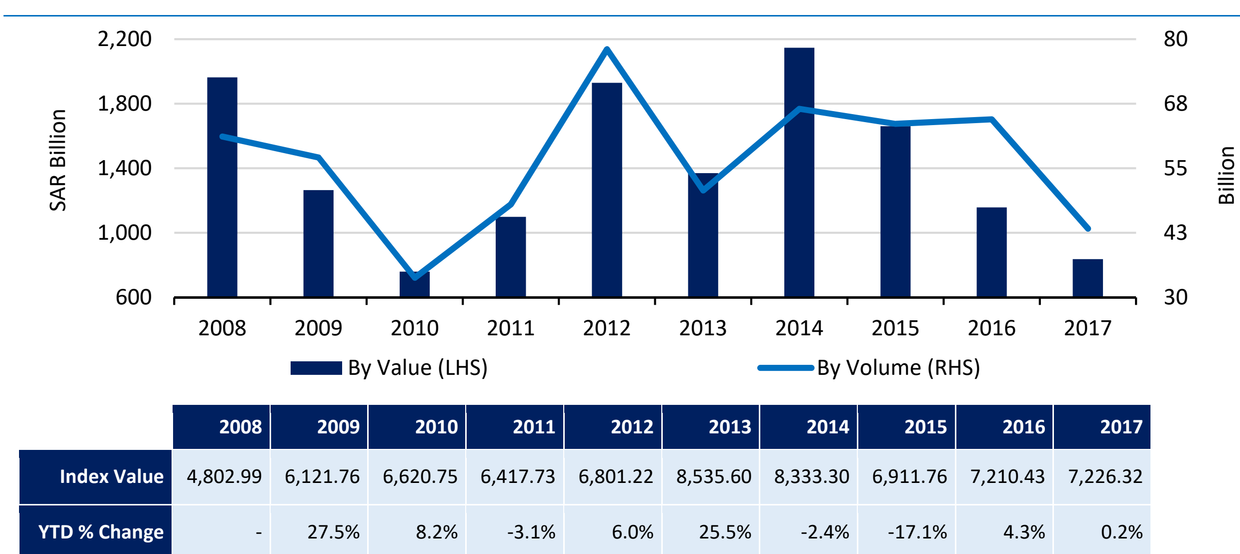
2017 also witnessed first steps towards a possible listing of Saudi Aramco, through an IPO in the near future. After being transformed into a joint stock company in early 2018, the process towards listing the company is gaining momentum. Valued at around SAR 7.5 trillion, Aramco would by far be the most valued listed company in the world, and selling a 5% stake of ARAMCO is expected to help raise about SAR 375 billion, about 20% of the current capitalization of the Saudi market. Considering the issue size,

participation by foreign investors will be the key to success and the recent exchange reforms are geared towards making them comfortable about investing in the Kingdom.

The success of the Aramco IPO, the biggest IPO ever globally, could provide greater flexibility to the government in its drive to boost economic diversification and also herald a fresh phase of fund inflows into the Kingdom. The IPO is crucial to the government's plans to transform the PIF, a major entity spearheading the Kingdom's diversification plans, into the world's largest sovereign wealth fund. Further, it would help support the inclusion of Saudi Arabia in the MSCI Emerging Markets Index. Saudi Arabia's potential 2.4% weightage in the MSCI Emerging Markets index could increase to 4.0% post the Aramco IPO, which would be greater than Russia's 3.4% weightage. Passive investment funds replicating MSCI indexes would need to allocate more funds to Saudi shares to match the country weighting resulting in investments of about SAR 50 billion. If active investors also increase their Saudi exposure in line with these weightings, total inflows into Saudi markets could reach SAR 250 billion. The CEO of the state-owned oil company, Mr. Amin Al Nasser, recently confirmed that the company is prepared to list in the second half of 2018, although the final listing date is not yet specified, and we expect to be delayed beyond 2018.

There are, however, challenges to managing the implications of the Aramco IPO. For one, the size of the IPO is enormous. To put this into context, all companies listed in Saudi Arabia over the past decade had a combined size of around SAR 75 billion at the time of listing compared to Aramco's expected SAR 375 billion. A public offering of such a size would impact the local market dynamics. It is expected that experienced investors adjust their portfolios to take exposure to Aramco, resulting in possible selling in other holdings. The trading value on the Tadawul has reduced from 2016 to 2017 and a large listing could be challenging. Additionally, there is a possibility that the correlation of the index to oil prices would increase substantially, making the market more prone to volatile oil prices, rather than to the diversifying Saudi economy. In our view, listing the company in the local market and one or more foreign exchanges would reduce the strain on the local market and also boost the company's profile internationally.

**Tadawul - Transactions Value and Volume**




| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Index Value** | 4,802.99 | 6,121.76 | 6,620.75 | 6,417.73 | 6,801.22 | 8,535.60 | 8,333.30 | 6,911.76 | 7,210.43 | 7,226.32 |
| **YTD % Change** | - | 27.5% | 8.2% | -3.1% | 6.0% | 25.5% | -2.4% | -17.1% | 4.3% | 0.2% |

*Source: Tadawul*

The government is looking to list Aramco's shares on the Tadawul stock exchange along with major global exchanges such as New York, London and Hong Kong. An exclusive listing on Tadawul together with a private placement to a strategic investor as a precursor to an international IPO is also an option. However, listing on foreign exchanges could expose the company to additional disclosures and compliance costs.

Another key Capital Markets initiative of the government has been the introduction of Real Estate Investment Trusts (REITs) which have gained popularity after the market regulator put the required framework in place for them to be traded on the stock market in 2016. As of December 2017, seven REITs were listed on the Tadawul, with a collective market cap of SAR 3.7 billion. Investment strategies of REITs in Saudi Arabia are split between specific-asset class approach and mixed-asset approach across asset classes in the region such as office, retail, education, residential, hospitality and logistics.

The REIT market has a huge potential given the long-term investment opportunities in the market. Many of the current REITs are promoted by local non-banks affiliated authorized persons, of which, some have an expertise in managing real estate funds. The REITs have provided these institutions an opportunity to increase their AUMs and client base. The major transformation in the REIT market will come from participation by key banking groups, who can bring in a larger breadth of clients to the market and make it deeper. We expect banks to strengthen their real estate market capabilities and their operations in the sector going forward and be a part of this market. The future of REITs will be defined by the number of distinctive properties that REITs can invest in and their ability to tie-up long-term lease agreements. Another opportunity is that the regulator has allowed for investment of up to 25% of capital in foreign assets or development projects or real estate related listed equities. We also expect players in the market to start looking for investment opportunities beyond the major cities, and increased use of leverage to lift yields. Meanwhile, in a sign that shows rising market maturity, REITs are now increasingly able to acquire assets at a relatively lower premium than before, with owners willing to sell a larger part of their properties.

One of the difficulties facing the REIT market lately is the under-subscription of some recent REIT IPOs. This absence of investor enthusiasm towards REIT IPOs could be attributed to the recent lackluster performance of existing REITs, which have seen their trading prices move below their nominal value. Additionally, a subscription fee that investors need to pay on IPO subscription is leading investors to increasingly favor buying REITs post listing. There is also a belief that the real estate assets which REITs are investing in are not of high quality, a concern which we believe is unfounded. Investors need to appreciate that investing in real estate needs to be done with a long-term perspective and the subscription fee is a business necessity, which the REITs charge to cover the cost of listing and marketing requirements. To ensure that investments are of sound quality and acquired at fair values, REITs managers conduct due diligence and a valuation exercise done by more than one valuator to ascertain the quality of these assets and their fair value. Over time, we expect the REIT market to mature further and boost private sector participation in the financing of real estate sector by enabling access to additional pools of capital, in line with the government's effort to stimulate the real estate sector.

In other capital market developments, the approval of NOMU-parallel market listing rules in early 2017, resulted in an alternative NOMU market. As of 31st December 2017, eight companies with a market cap of about SAR 2.2 billion were listed on NOMU. Its objective is to provide an opportunity to a wider spectrum of issuers to list their shares on the stock exchange with relatively less stringent listing rules. NOMU also allows private equity funds managers to exit their investments through listing on its platform.

Further, the Capital Market Authority, in an effort to make the capital market more accessible to foreign investors gave them full access to the NOMU market from January 2018. In NOMU, foreign investors will no longer have to meet requirements to qualify as foreign institutional investors, although they will have to obey limits on foreign ownership of stocks. We expect that the establishment of NOMU and the opening-up of capital markets will enable the Kingdom to attract foreign investment and also provide SMEs the chance to tap into additional capital resources to expand their businesses.

One of the most talked-about topics in the financial sector today is blockchain. The technology is expected to transform the banking sector by enabling banks to process payments more quickly and more accurately while reducing transaction costs. Banking on the potential of blockchain technology to speed-up transactions and reduce costs, the Saudi central bank, SAMA, has signed a deal with the US-based fintech company, Ripple, to help banks improve their payments network and speed up money transfers. According to Moody's, the deal is likely to translate in a system-wide savings of roughly SAR 750 million - SAR 1,500 million every year. SAMA is also working with the central bank of the UAE on the blockchain technology to issue a new digital currency which would be accepted in cross-border transactions between the two nations.

On the global front, equity markets enjoyed robust gains in 2017, as better than expected global economic growth and subdued inflation buoyed investor sentiment. Global markets soared to new highs amid an environment of low volatility, on the back of solid corporate earnings and mostly upbeat macro-economic releases. The passing of widely anticipated tax cuts in the US by President Donald Trump in December 2017, also acted as a catalyst for the rise in global equities. Chinese and other Emerging Markets also benefitted from the synchronized global growth. The US Fed raised its key interest rates three times during 2017 and even started tapering its QE program. For 2018, the US Fed has projected three more rate hikes and in case inflationary pressures begin to materialize, we could see a faster than expected tightening of monetary policy. This could drive the US Dollar higher and push bond yields up, affecting equity markets adversely. Although such fears and concerns about already high valuations pose a downward risk to global equity markets, expectations of rising corporate earnings following the US tax overhaul are likely to keep sentiment buoyed.

**Social Reforms: Tourism is a Key Focus Area**

The Kingdom's efforts towards social reforms are aimed at developing the tourism and entertainment industries and expanding the consumer markets. Initiatives for women have the potential to expand the consumer market, as well as drive growth through their participation in the labor market. The Saudi Commission for Tourism and National Heritage, in early 2017, allocated SAR 3 billion to be spent over three years on hotel and tourism projects in the Kingdom, with the aim to attract 1.5 million non-pilgrim tourists by 2020.

New projects along the Red Sea coast, the Jeddah waterfront and the construction of the massive mega city 'NEOM' are all geared towards creating job opportunities and to bolster the nation's GDP. The estimated SAR 1,875 billion NEOM city will span across the borders of northwest Saudi Arabia into Jordan and Egypt and will be powered entirely by wind and solar energy. The 26,500 square kilometers zone will be designed to operate as an independent economic trade zone with its own governmental framework, including different taxation, customs and labor laws and will be home to a host of potentially attractive industries, including biotechnology, food, advanced manufacturing and entertainment. NEOM's strategic location will also facilitate the zone's rapid emergence as a global hub connecting Asia, Europe and Africa.

The city is expected to feature state-of-the-art technologies, and is intended to inspire a "new generation of cities" with clean energy powering the urban landscape. The Kingdom aspires NEOM to be "the safest, most efficient, most future-oriented, and best place to live and work." The first phase of the city is expected to be completed by 2025.

The Red Sea project, construction for which is anticipated to start in the latter part of 2019, is designed to develop the region into a global tourism destination. The first phase of construction is anticipated to be completed by 2022. These developments, which would have been difficult to envisage just a few years back, give us high confidence in our belief that a new era of development is about to start in the nation. The government is also planning to build a one of its kind world-class entertainment and leisure city in Al Qidiya. The recent lifting of ban on cinemas could see building of about 300 cinema halls over the next decade.

The plans for the development of the Al Faysliah City, situated in the west of Makkah, include construction of residential units, entertainment centers, an airport and a sea port. The city is expected to provide about 995,000 housing units and accommodate around 6.5 million people by 2050 and will create one million jobs in the region in sectors such as healthcare, education and technology & services. The Jeddah Tower, slated to be completed in 2019, is set to eclipse the Burj Khalifa as the world's tallest building, with projected height of over 1,000 meters. Built at an estimated cost of about SAR 5.6 billion, the tower is expected to be a major tourist attraction. Our view is that when completed, these projects will become prominent landmarks and meet the employment, recreational, cultural and social needs of future generations, as well as boost consumer spending.

The hospitality and tourism industry is currently driven by pilgrims visiting the holy cities of Makkah and Madinah, and the corporate and leisure activities which are concentrated in and around Riyadh. The development of the King Abdullah Financial District and Entertainment City is likely to boost demand for corporate and leisure hotels in the capital. Supply of branded hotel rooms in Makkah is expected to grow at a CAGR of about 18% over the 2014 to 2019 period, particularly to cater to the growing demand from pilgrims. Major operators such as Jumeirah Group, Emaar Hospitality and Four Seasons have announced plans to increase their presence in the region.

In an effort to boost religious tourism, the Public Investment Fund, in 2017, formed two real estate development companies to bolster the capacity of Makkah and Madinah to accommodate more pilgrims. The project aims to build about 70,000 new hotel rooms and 9,000 housing units in Makkah and 80,000 hotel rooms and 500 housing units in Madinah which could contribute about SAR 8 billion annually to the nation's GDP by 2030. We believe that given the exorbitant cost of land around the holy mosques, the government should consider extending the lease period for lands for periods longer than 50 years to attract more international hotel operators to make substantial investments. Another issue that development around Makkah faced was that very high heights of newly developed properties impacted the value of properties around these sites. The government needs to consider all facets so as to avoid facing similar challenges.

The government's decision to increase Hajj and Umrah visas and projects, aimed at increasing the capacity of airports, along with the start of the Haramain High Speed Railway line, will provide additional impetus to religious tourist inflows and drive the tourism market in the coming years. The government decision to start issuing tourist visas from the first quarter of 2018 will reduce the Kingdom's dependence on seasonal

religious tourism. The move has the potential to attract global as well as GCC visitors into the Kingdom and help in development of new tourist spots.

We believe that reforms related to women will help develop existing markets and create new consumer segments over time. The lifting of ban on women drivers opens-up a market for cars, with over 6 million females between the ages of 25-64. Increased encouragement to raise women participation in the jobs market and allowing women to attend live football games and concerts is expected to result in more and more women spending time outdoors, leading to increased spend on entertainment and on food in restaurants. These developments are expected to not only aid economic growth, but also herald a change in the nation's culture. In another development, Saudi became the first country to confer citizenship to a robot, Sophie, in October 2017, and it was named the United Nations Development Program's first ever Innovation Champion and the first non-human to be given any UN title.

## PIF - The Catalyst for Saudi Private Equity Industry

The Saudi private equity industry is small by global standards. However, the increasing role of the Public Investment Fund is expected to boost investment activity and create opportunities for private equity investment in the Kingdom. The government plans to increase the PIF's financial clout to SAR 1.5 trillion by 2020, and it is anticipated to play a central role in the nation's reform and investment plans. The Fund, through its Program 2018-2020, plans to create 20,000 direct jobs, more than half of which would be high-skilled jobs and about 256,000 construction jobs by 2020 by investing in the real estate and infrastructure sectors. Its combined SAR 243.8 billion investment in Blackstone Infrastructure Fund and SoftBank's Technology Fund have put PIF firmly in the global spotlight. The PIF is already an investor in some of the Kingdom's largest companies, including Saudi Telecom, Saudi Arabian Mining and The National Commercial Bank and has the potential to become one of the world's most powerful sovereign wealth funds.

The PIF's latest funding venture, a new SAR 10 billion entertainment investment company, will invest in several projects in the Kingdom, including an entertainment complex to be launched in 2019 and will also seek partnerships to expand the scope and variety of entertainment offerings. By 2030, the new entity's projects are expected to attract more than 50 million visitors annually and create more than 22,000 jobs in the Kingdom, contributing around SAR 8 billion to the Kingdom's GDP. In 2017, the PIF established a Fund of Funds, a new investment vehicle with a capital of SAR 4 billion, to empower the private sector by providing local SMEs with access to capital by investing in venture capital and private equity funds. We expect the Fund of Funds to create a favorable private equity and venture capital ecosystem in Saudi Arabia.

Furthermore, the government's privatization and investment plan is likely to attract interest - both domestic as well as international. The Kingdom is actively seeking foreign investments in the next phase of its development. KKR, Citigroup, Goldman Sachs and Credit Suisse are among a growing band of western investment banks and private equity firms expanding in the Kingdom. Blackrock has confirmed its intension to open an office, and Blackstone is also reportedly looking to do the same.

Additionally, the NOMU market will, over time, enable private equity players to exit their investments through a relatively hassle-free listing process. As indicated earlier, the NOMU has less stringent listing rules and would enable private equity players to list companies of relatively small size, with limited infrastructure, financial disclosures, and corporate governance. Further, in a relatively subdued mergers and acquisitions market, exiting via a NOMU listing would be an attractive proposition for private equity players.

The spate of socio-economic reforms and investment plans announced by the government in 2017 have reinforced the government's commitment to its vision of becoming an investment-driven economy. The key sectors that are expected to benefit and attract foreign private equity investments in the Kingdom include retail, education, healthcare, and tourism & entertainment. We expect the possible inclusion of Saudi Arabia in the MSCI Emerging Markets to further fuel overseas interest in the nation. The planned relaxation to allow 100% foreign ownership in the healthcare and education sectors is expected to open-up large investment opportunities and attract substantial investments from fund managers under the government's planned privatization drive. Another sector that has seen plenty of activity recently is the e-commerce sector. In 2017, Amazon acquired Souq.com, often described as the Amazon of the Middle

East, for SAR 2.2 billion, while online retailer Noon, bought a controlling stake in rival Namshi for around SAR 1.1 billion. GlamBox Middle East, a Dubai based online subscription service for beauty products, looking for expansion in Saudi Arabia and the rest of GCC, was acquired by a consortium of Saudi based investors. We have already discussed the potential for investments in the tourism sector in the nation in the earlier part of the report. Bloomberg reported in November 2017 that Japan's SoftBank Group plans to invest over SAR 90 billion, over the next few years, partly in NEOM and partly in the electricity sector.

Compared to large opportunities opening-up in Saudi Arabia, the global private equity landscape looks somewhat challenging, especially with easy liquidity driving up valuations. Globally, the year 2017 was in line with the recovering trend we have been seeing in the global private equity market since the 2008 global financial meltdown. Fundraising is set to scale new highs in 2018, with data indicating that private equity firms had raised $637.3 billion at the end of 2017, up 5% on an annual basis. The popularity of buyout funds has continued to rise and accounted for about 47% of funds raised.

There are a few key broad trends in the global private equity marketplace that we would like to highlight.

- Elevated Valuations: Following the strength in the global equity markets over the past few years, asset valuations have moved higher, and fund managers are being forced to work harder to find attractive deals.
- High Liquidity to Continue to Fuel Competition for Deals: Global private equity funds were estimated to be sitting on record liquid funds of $633.8 billion the end of 2017, higher by 13.0% since the end of 2016. With the high amount of liquidity available to private equity funds, competition for attractive assets will only intensify.
- Competition from Cash Rich Corporates Rising: High equity valuations and robust balance sheets are driving many corporates to explore opportunities to grow inorganically. One of the most prominent deals that failed to materialize last year was Kraft Heinz's $143 billion offer for Unilever Plc. Although the deal fell-through, we believe that it is perhaps a sign of things to come, where cash-rich corporates will go toe-to-toe with private equity firms in acquiring other companies.

Going forward, we believe that global liquidity conditions will remain easy despite some Fed tightening. In this global environment, we believe that opportunities for investments offered by the Saudi market over the next decade are attractive and funds operating here will be able to take exposure to good businesses at reasonable valuations.

## Government Steps-in to Revive Saudi Real Estate Sector

Saudi Arabia's real estate sector, which experienced a significant slowdown in 2016, continued to witness softness through 2017, as low occupancy levels across most asset classes led to a gradual softening of rents. Besides low oil prices, limited access to finance and availability of developed land continue to affect demand. With the local industry facing a slowdown, companies are also looking at overseas markets for expansion.

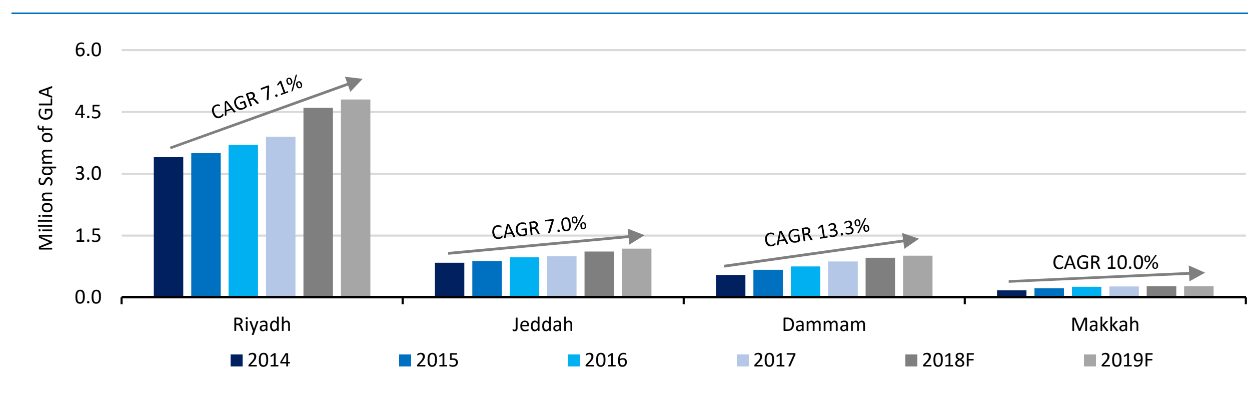
The government launched several initiatives to address the challenges faced by the real estate sector, such as the white land tax and affordable housing schemes, among others, which are expected to improve availability of land and lower prices, which in turn will help spur demand going forward. According to a recent JLL report, the white land tax seems to be having the desired effect, with a visible rise in development interest and an 18.5% decrease in average land prices in the four cities of Riyadh, Jeddah, Dammam and Makkah in 2017. The nation's Housing Ministry distributed 18,000 affordable residential houses in Riyadh during the third quarter of 2017 and is in talks with potential investors from Asia to build 1 million low-cost homes over the next five years. In January 2018, the Housing Ministry along with the Real Estate Development Fund launched the first batch of the Sakani II program, under which 300,000 housing and financing products, including residential units, residential plots and subsidized loans will be provided to people. We believe that the white land tax will increase the supply of land and aid the government's affordable housing scheme.

The private sector has also shown a keen interest in the Saudi real estate market and the government will spend more than SAR 59 billion until 2020 in collaboration with the private sector to make housing finance available to locals at affordable rates. The government, which currently provides about 65% of all loans, is looking to increase private sector participation in the mortgage market. Under revised housing rules, SAMA has announced plans to scrap administrative fees which would allow mortgage holders to switch from one lender to other without incurring any extra cost. Also, the General Authority for Zakat and Income Tax has stated that no VAT charges will be levied on mortgage loans and leases that were signed before 1st January 2018. The Saudi Real Estate Refinance Company, launched in October 2017, will inject additional liquidity into the real estate financing market to expand the market by over 70% to SAR 502 billion by 2030. The above reforms are in line with the government's strategy to increase home ownership among Saudis from 50% to 60% by 2020 and to 70% by 2030.

International players are also showing interest in the Saudi real estate market. The SAR 75 billion Dahiyat Al-Fursan residential project in Riyadh, to be built jointly by Daewoo Engineering & Construction, Hanwha Engineering & Construction and the Saudi Pan Kingdom Company, is possibly one of the largest investments by a private player in the nation. The project will see the consortium building a new residential city with a population of 100,000. Ongoing projects such as King Abdullah Financial District and the Jeddah Waterfront are also expected to change the dynamics of the commercial real estate market in Saudi Arabia.

Below, we explore the performance and outlook for the major segments in the real estate sector in Riyadh, Jeddah, Dammam and Makkah.

### Office Market Supply

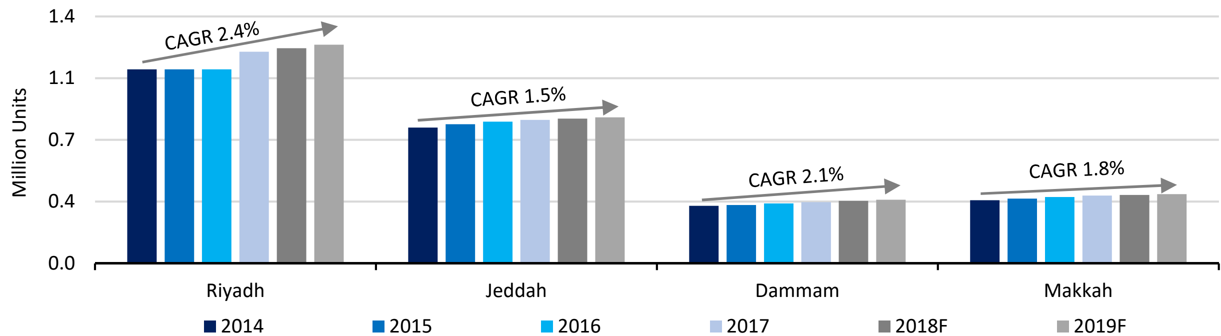



### Office Market - Performance and Outlook

| | Riyadh | Jeddah | Dammam | Makkah |
|---|---|---|---|---|
| **Major Developments in 2017** | Approximately 144,000 sqm of office Gross Living Area "GLA" completed in 2017, bringing total GLA to 3.9 mn sqm as of Q4 2017. | Office GLA stood at 1 mn sqm in 2017. Delays in construction were witnessed due to landlords' inability to secure funding for completion of projects. Landlords were also cautious to inject more capital in projects until market conditions improved. | Approximately 144,000 sqm of office GLA completed in 2017, bringing total GLA to 870,000 sqm as of Q4 2017. | Following the completion of several projects in H1 2017, no completions were witnessed in H2 2017. |
| **Supply Outlook** | New supply to rise significantly, with around 660,000 sqm currently slated to complete in 2018. Riyadh metro will have a major impact on the market in the coming years. Proximity to metro stations could be a major factor in deciding tenants' location choices. | New supply is expected to reach 108,000 sqm in 2018 and 69,000 sqm in 2019. | New supply is expected to reach 90,000 sqm in 2018 and 50,000 sqm in 2019. A notable supply of small offices (< 10,000 sqm) is expected to enter the market. | With no new projects announced, very little office supply is likely to enter the market in the near term. |
| **Performance Outlook** | Market is likely to remain soft in 2018. Competition from new projects, particularly the King Abdullah Financial District, will put downward pressure on rents and occupancies. | Weak demand and rising supply resulted in a steady decline in rent through 2017. New supply expected to hit the market in 2018 is likely to further depress rents. | The market remained soft in 2017, largely due to the slowdown in local economy. With supply expected to outstrip demand, market softness is likely to persist in the short to medium term. | Limited new office supply could result in stabilization of rents. |

*Source: JLL - Saudi Arabian Real Estate Market Report 2017*

## Residential Market Supply

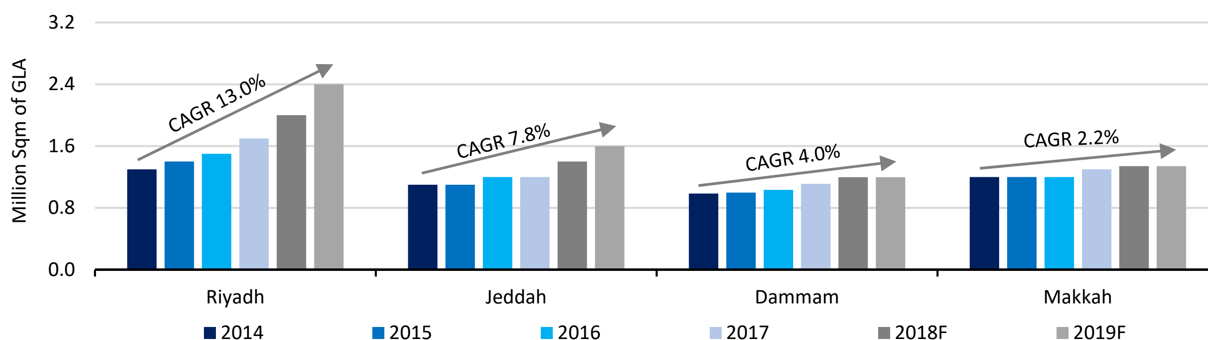



## Residential Market - Performance and Outlook

| | Riyadh | Jeddah | Dammam | Makkah |
|---|---|---|---|---|
| **Major Developments in 2017** | About 19,500, mostly stand-alone units, completed in 2017. Total residential stock stood at 1.2 mn units as of Q4 2017. Supply of rental units for executives, expatriates and tourists continued to grow, while affordability of mainstream residential units remained a concern. | Supply increased slightly to 813,000 units in 2017. | About 7,000 completions in 2017, mostly stand-alone villas and apartment buildings. | About 8,000 units completed in 2017. Total residential stock stood at 384,000 units as of Q4 2017. |
| **Supply Outlook** | High-rise developments are witnessing an increase in high quality and luxury offerings. | A large number of planned master communities in the pipeline is expected to boost supply in the coming years. | 7,000 new units expected to enter the market in both 2018 and 2019. | With a large number of mega projects not expected to be completed in the near term, short term supply is likely to remain subdued. |
| **Performance Outlook** | The number of apartments transacted in 2017 rose 12% YoY, although rents declined by about 4% YoY. Decline in rents could continue, driven by the levy on expat dependents, which will increase progressively in the coming years. | Prices and rents declined in 2017, with the combined value of residential transactions declining by 4.4% in 2017. Demand for rentals is likely to remain soft, on the back of the introduction of the expat levy. | The number of apartments transacted in 2017 rose 11% YoY. Changes to housing allowance regulations in December 2017 could negatively impact housing budgets and put downward pressure on the housing market in the long term. | Rents are expected to continue to soften in 2018. |

*Source: JLL - Saudi Arabian Real Estate Market Report 2017*

### Retail Market Supply

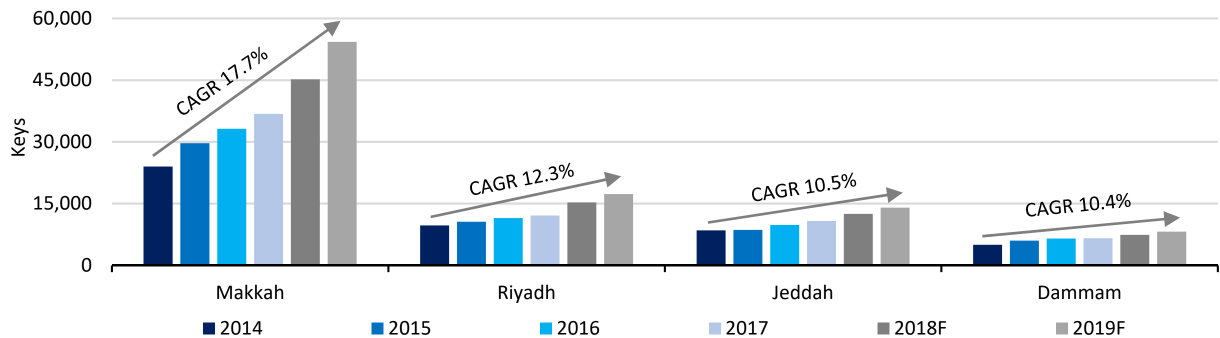



### Retail Market - Performance and Outlook

| | Riyadh | Jeddah | Dammam | Makkah |
|---|---|---|---|---|
| **Major Developments in 2017** | Approximately 250,000 sqm of retail space entered the market in 2017, with no major completions. | The partial opening of the Jeddah Park was a major completion in 2017. About 12,000 sqm of supply due in 2017 was pushed into 2018. | Approximately 77,000 sqm of retail GLA entered the market in 2017, more than double that in 2016. The total stock of retail GLA stood at about 1.1 mn sqm as of Q4 2017. | Following the completion of about 7,000 sqm of retail space in H1 2017, no notable completions were witnessed in H2 2017. |
| **Supply Outlook** | The market is likely to witness over-supply over the next two years, with expected completion of about 250,000 sqm in 2018 and 415,000 sqm in 2019. Majority of new supply is situated in the northern area to cater to the increasing population in the region. | The lifting of ban on cinemas could potentially result in an increase in retail GLA. | New supply is expected to reach 85,000 sqm in 2018. | Total expected supply in 2018 is about 37,000 sqm, with the Jabal Omar Development alone adding about 24,000 sqm to the retail market.<br>With a large number of mega projects not expected to be completed in the near term, short term supply is likely to remain subdued. |
| **Performance Outlook** | The retail sector was relatively stable in 2017. With several international cinema chains looking to enter the Saudi market and the limited options currently available in the city, Riyadh stands to benefit. It is expected also to witness many vacant retail shops in the coming period. | Tenant negotiating power strengthened towards the end of 2017 due to uncertainty in markets and the trend is likely to continue in the near term. It is expected also to witness the vacancy of many retail shops in the coming period. | Dammam is expected to witness vacancy of several retail shops in the coming period. Performance of shopping centers could pick-up, following the opening of cinema halls. | Retail performance softened in the H2 2017 and the trend is likely to continue in the near term. It is expected also to witness the vacancy of many retail shops in the coming period. |

*Source: JLL - Saudi Arabian Real Estate Market Report 2017, Alkhabeer Capital*

**Hotel Market Supply**




**Hotel Market - Performance and Outlook**

| | Riyadh | Jeddah | Dammam | Makkah |
|---|---|---|---|---|
| **Major Developments in 2017** | Approximately 600 keys entered the market in 2017. Total stock of quality hotel rooms stood at 12,000 as of Q4 2017. | Total stock of quality hotel rooms stood at 10,800 keys as of Q4 2017. | Total stock of quality hotel rooms stood at 6,600 keys as of Q4 2017, with only one new completion in 2017. | Approximately 5,600 keys entered the market in 2017. Total stock of quality hotel rooms stood at 36,800 as of Q4 2017. |
| **Supply Outlook** | A significant number of rooms are expected to be added over both 2018 and 2019, although delays to the pipeline could be expected. | About 1,700 new rooms are expected to enter the market in 2018, with most of the projects at an advanced stage of completion. | About 800 new rooms are expected to enter the market in both 2018 and 2019. | About 17,500 new rooms are expected to enter the market over the next two years. |
| **Performance Outlook** | Performance continued to weaken through 2017, on the back of declining demand from business travelers and additional room supply.<br>The expected increase in supply over the next two years could further dampen the market in the short term.<br>Demand from leisure sector is likely to increase, following the government decision to issue tourist visas in Q1 2018. | Performance is expected to remain weak in the short term, on the back of decline in demand from corporates.<br>However, with the leisure sector yet to reach its full potential, long term outlook remains positive. | Performance is expected to continue to soften in 2018. However, the government's decision to issue tourist visas in Q1 2018 could result in a pick-up in demand. | With the government committed to grow the number of pilgrims, long term outlook remains positive. |

*Source: JLL - Saudi Arabian Real Estate Market Report 2017*

The Capital Market Authority's decision to allow listing of REITs on the exchange will bring more transparency in the real estate market over time and increase participation of private players in the financing of real estate projects. The REITs are investing most of their funds currently in income generating properties within Saudi Arabia. Retail centers, offices, residential apartments, warehouses and hospitals in and around Riyadh, Jeddah, Makkah, Dammam and Al Khobar have been the main acquisition targets of the REITs. The government's decision to lift Hajj quotas in 2017 has attracted REITs to the holy cities of

Makkah and Madinah, with primary focus on properties in the hospitality sector, to cater to the growing demand from Hajj pilgrims. We expect that as the industry matures over time, REITs will look to invest in assets beyond the major cities and use leverage to raise yields, thereby positively impacting the overall real estate sector.

In our view, the initiatives announced by the Saudi government to stimulate the real estate market, such as easing of mortgage regulations and the drive to build affordable houses, among others, will attract more investments from the private sector. However, the government will have to scrutinize conditions and adjust policies to avoid a housing market bubble, as the slew of measures announced could lead to an increase in house prices and defaults. On the other hand, the expected decline in expatriate population following the introduction of the expat levy is likely to put downward pressure on rentals and occupancy levels. While the government's efforts to stimulate the real estate sector will take time to filter through, we believe that these initiatives are a step in the right direction for the development of a more active real estate market in the coming years.

Globally, investments into real estate continued to grow in 2017, led by low interest rates. A recent Knight Frank report indicates that global house prices rose 5.1% annually in the third quarter of 2017, while Cushman & Wakefield expects global real estate investment volumes to grow at an annual rate of 1.5% in 2017. We expect the real estate market to remain strong through 2018, driven by robust global economic growth, though price gains could be capped amid modest tightening by the US Fed.

## Reforms and Investments to Drive Long Term Growth

2017 can be termed as a year of transformation for Saudi Arabia's economy as a series of economic reforms were announced to revive sagging growth and diversify the oil-dependent economy. 2017 also witnessed a contraction in real GDP, as the continued decline in oil-revenues outweighed the robust growth in the non-oil sector. With the current regime focused on guiding the nation's economy away from its oil dependency, we expect the non-oil sector to play an even more important role in the growth narrative in the coming years. Oil will, however, continue to remain a key part of the Kingdom's fortunes, at-least in the foreseeable future, and the recovery in oil prices in the latter part of 2017, driven by the OPEC production cut deal, bodes well for the economy for 2018.

The recovery in crude oil prices has enabled the government to boost its spending to a record level, with austerity given a silent burial in the 2018 budget. The expansionary budget, along with the reforms announced during the year, will not only boost economic growth, but also generate additional sources of income in years to come. Moreover, a slew of measures announced to nationalize jobs and additional levies on expats will enhance job opportunities for locals and help reduce the unemployment rate in the long-term. However, we expect that the government continues to address the short-term adverse impact of these levies on the economy to attain sustained growth.

Several tax reforms, such as the sin tax, boosted government coffers in 2017. Moving forward, VAT, the energy and water subsidy cuts and gasoline and utility price hikes are expected to further bolster revenues in 2018. The new taxes and price hikes will drive inflation higher and will impact consumer spending in the short-term. However, the Citizens Account Program will help reduce the burden of higher costs on the lower-middle income classes. Overall, we believe that the long-term benefits of these measures, including reduced dependence on oil and increased government revenue, far outweigh the drawbacks.

Capital market reforms implemented over the past few years could see the Kingdom being added to the MSCI Emerging Markets Index soon. The listing of Saudi Aramco could change the dynamics of the local market forever and give the Kingdom a shot-in-the-arm to move forward with its privatization drive. A listing on the Tadawul, along with one or more major global exchanges, is in the pipeline and would help boost the profile of the domestic equity market. However, the size of the issue poses challenges and needs to be managed well. Meanwhile, several REITs hit the local markets in 2017, and despite some hiccups witnessed lately, the sector remains attractive, given the long-term investment opportunities in the market. We believe that investors will become more receptive to REIT funds, as their popularity will increase among investors who are targeting regular-income investments such as corporates, Waqf entities, and individuals, which will boost real estate investments in the Kingdom and encourage private sector participation in the financing of real estate sector by enabling access to additional pools of capital.

The government has sought to address the continued weakness in the real estate sector by launching several initiatives to address the challenges faced by the sector, such as the white land tax and affordable housing schemes. On the other hand, the effect of the expat levy has the potential to exert downward pressure on housing demand and result in lower rents and occupancy rates. However, we believe that growing interest from the private sector as well as international players, along with the government's various mega projects, will drive the real estate sector going forward.

The Kingdom also took steps to draw private equity investors to its shores through its sovereign wealth fund - the PIF. With major global Private Equity players and investment banks looking to increase their

presence in the Kingdom and the government enacting friendly business policies, we believe the Saudi private equity market is poised for growth in the coming years. The government's privatization initiative is also expected to attract local and global PEs, with sectors such as retail, education, healthcare and tourism poised to witness significant activity.

Besides economic reforms, the Kingdom focused on developing its tourism and entertainment industries in 2017. The various mega development projects, including 'NEOM' and the leisure city in Al Qidiya, have the potential to make the Kingdom a global tourism and entertainment destination. Further, plans to augment the accommodation capacity in Makkah and Madinah will boost religious tourism. The decision to overturn the ban on public cinemas and the measures taken to encourage the participation of women in the society are not only symbolically significant but will also help drive consumer spending and enable additional employment opportunities.

With the progressive policies of the government, we expect the reform process in Saudi Arabia to continue and growth to pick-up pace, as investment opportunities open-up.

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