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Report Series

June 2010

Key Sectors in Saudi Arabia: Historical Performance and Outlook

Executive Summary

- The Saudi economy is recovering from last year's near-recession. This report attempts to gauge which sectors of the nonoil economy are likely to rebound most forcefully in 2010-11.

- We examine the historical performance of key sectors during past oil price slumps (1986, 1988 and 1998). We also take a look at the government's spending priorities during the current period and the financial performance of companies listed on the Saudi stock market.

- We find that Agriculture and Manufacturing have tended to recover quickest from previous slumps, while Construction and Trade have typically lagged the recovery.

- In 2010 Manufacturing is again leading the way, while Agriculture is also putting up a good showing. These sectors are expected to remain at the forefront of the recovery.

- However, thanks to the government's spending surge, which has supported real incomes, Trade has also been boosted and should continue to accelerate as confidence hardens.

- Based on the financial performance of listed firms, Construction seems again to be lagging the general recovery. However, the results are skewed somewhat by the broad range of companies included in this category, and we think that pure contracting firms will do well this year.

- Meanwhile, Finance might see stronger domestic asset growth in 2010, but narrowing loan spreads are likely to weigh on profitability.

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Office of the Chief Economist
Economics Department
Samba Financial Group
P.O. Box 833, Riyadh 11421
Saudi Arabia

ChiefEconomist@samba.com
+9661-477-4770; Ext. 1820 (Riyadh)
+4420-7659-8200 (London)

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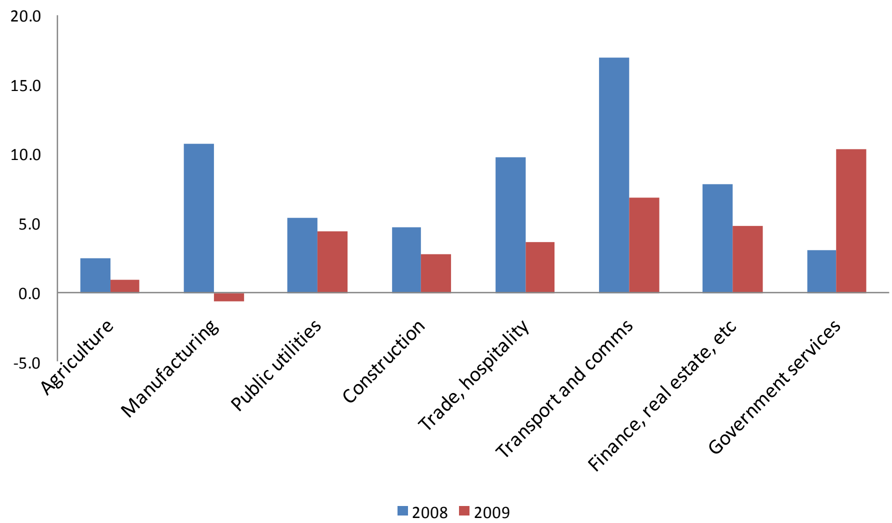
1. Introduction

According to official figures, the Saudi economy avoided recession in 2009, growing by 0.2 percent in real terms, with the nonoil economy expanding by 3 percent. In nominal terms, the nonoil economy grew by 5.3 percent.

The 2009 downturn was severe

However, these broad figures do not capture the severity of a downturn that began in mid-2008, with the intensification of the global financial crisis, and encompassed all of 2009. As global wholesale banking markets seized up and oil prices plummeted, domestic banks retrenched and consumption and investment quickly fell away. Almost all nonoil sectors were impacted.

Chart 1: Nominal Nonoil GDP by Sector
(percent change, 2008-09)



The government's counter-cyclical stance has provided the platform for a return to growth

As we will see, a countervailing pickup in government spending helped to stabilise the situation and has provided the platform for a return to growth this year. The recovery is embryonic, however, and there are, in any case, no quarterly GDP data to allow us to track which sectors are recovering—or are likely to recover—fastest.

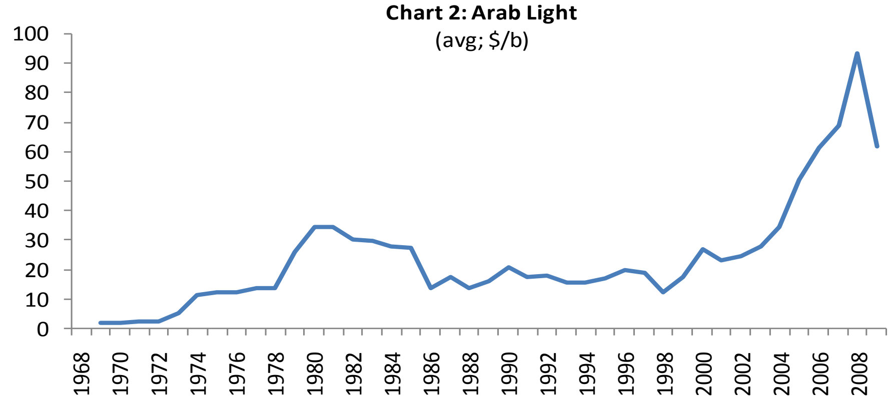
The aim of this paper is to use previous recessionary periods to identify which nonoil sectors are likely to recover most forcefully. We will also consider the government's spending priorities, given that the direction of public spending has a pronounced influence on how particular economic sectors fare.

Previous recessions shed light on how the 2010-11 recovery might evolve

2. Historical Performance

We have identified three previous downturns in Saudi Arabia's economic history which may shed light on the dynamics of the current recovery. Each was triggered by a sharp fall (more than 20%) in the price of Arab Light. The downturn years are **1986**, **1988** and **1998**.

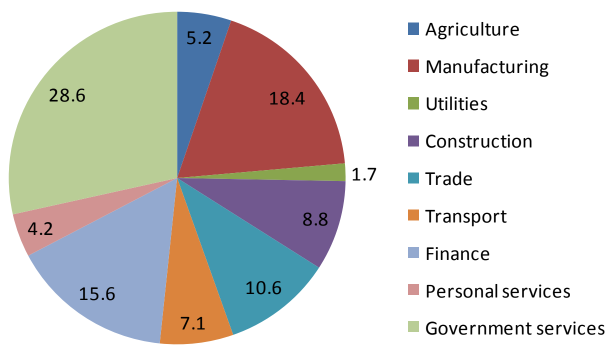
Chart 2: Arab Light
(avg; $/b)



Having identified the years, we need to understand how each main economic sector responded both during the "crisis year" and in the two years following the downturn. First, we identify the main sectors of the nonoil economy. By rank in nominal terms they are:

1. Government services
2. Manufacturing (including oil refining and petrochemicals)
3. Finance, insurance, real estate, & business services
4. Trade and hospitality
5. Construction
6. Transport, storage & communications
7. Agriculture
8. Community and personal services
9. Public utilities

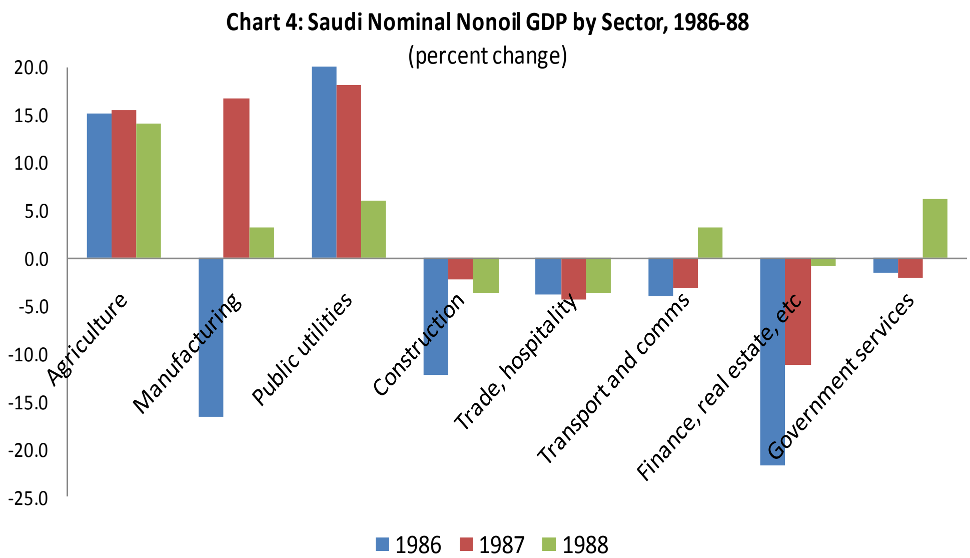
Chart 3: Nonoil GDP by Sector, 2009
(percent)



1986

The 1986 oil price slump was a major shock to the system

The 50 percent slump in the price of Arab Light was the first major downturn in oil prices in living memory, and was therefore a major shock to the system. The period also incorporates a “double dip” recession, given that oil prices fell by more than 20 percent in both 1986 and 1988. For convenience, we are treating 1988 as the start of a separate downturn, but it is worth bearing in mind that the recovery from the 1986 slump was impacted by the subsequent oil price fall in 1988.



Finance, Construction and Manufacturing suffered more than most

Chart 4 shows that **Finance & real estate**, **Construction**, and **Manufacturing** suffered significantly more than other sectors during the slump year, declining by 22 percent, 12 percent and 17 percent respectively. The poor performance of **Finance** is of little surprise: the flow of bank credit depends on two key elements—liquidity and confidence—both of which shrunk dramatically in 1986 as oil export earnings slumped. Consequently, bank credit, which had been growing steadily throughout the 1980s, fell by 5 percent in 1986. **Construction** in turn depends on credit and confidence (at least for private sector projects), but with bank lending to this sector slumping by 20 percent in 1986, it fell into recession. In 1986 **Manufacturing** was composed largely of refined products, rather than petrochemicals. The global price of refined products is determined by oil prices, which explains the sector’s sharp decline that year.

It is notable that of these three sectors, only **Manufacturing** was able to bounce back into growth the following year, as oil prices rebounded by about 25 percent. In 1988 oil prices fell again (see below) and Manufacturing’s recovery was short-lived. **Construction** remained in recession for the next two years: in 1986 the authorities had nothing like the stockpile of foreign assets that they enjoy today. Thus, when oil prices fell, capital spending was quickly reined in, and construction suffered. The

Finance & real estate sector also continued to shrink, though here the downward pull was from real estate and business services; bank lending actually recovered in 1987.

Trade suffered from reduced liquidity and confidence

Of the other sectors, **Trade & hospitality**, **Transport & communications**, **Personal services**, and **Government services** (essentially current spending) all witnessed comparatively moderate declines in 1986. **Trade** was the hardest hit of these sectors as reduced liquidity squeezed retail activity. The jolt to confidence was such that the sector did not recover in 1987 and was hit again in 1988 as oil prices dipped further. **Transport** is closely correlated to Trade and it remained in recession in 1987, though it did manage to post modest growth in 1988.

Government services stayed in recession in 1987 despite the fact that public spending actually increased quite sharply in nominal terms. This is likely a result of lags: government spending would have risen only gradually during the course of 1987 (in line with recovering oil prices) and the impact of much of this spending would have been felt only in 1988.

Of all the sectors, **Agriculture** posted the most consistently robust growth over the three years. At the time, agricultural self-sufficiency was still a cornerstone of government policy, and public investment in the sector remained firm.

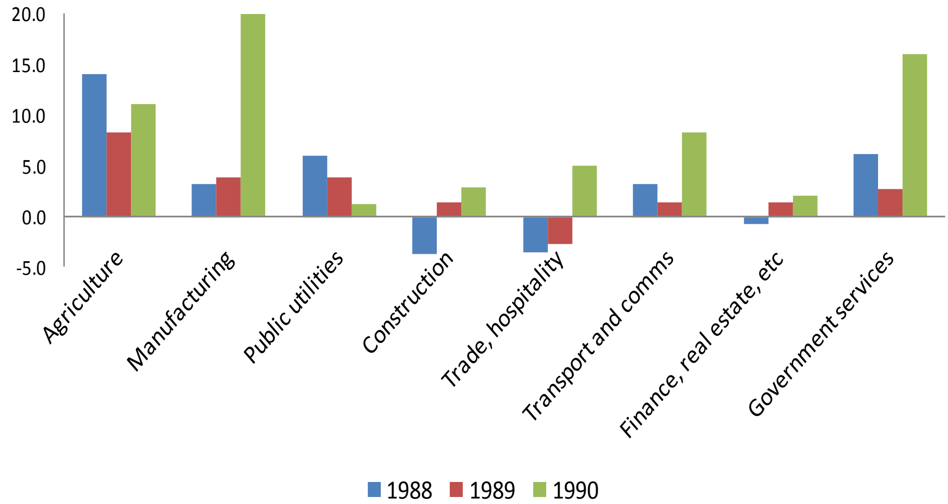
1988

The economy had "less far to fall" in 1988

The 1988 oil price slump was not as severe as that of 1986. The average price of Arab Light fell by 22 percent in 1988, compared to the 50 percent decline in 1986. Moreover, the subsequent years saw a more forceful and lasting rebound in oil prices, with Iraq's invasion of Kuwait in August 1990 helping to lift prices by 28 percent in that year. In addition, having been through a recession in 1986, there was "less far to fall" in 1988.

This is reflected in **Chart 5**, which shows that the 1988 oil price fall had a much shallower impact on economic activity than two years earlier. Oil-price-sensitive sectors such as **Construction**, **Trade**, and **Finance & real estate** all dipped back into recession, but the declines were not severe. Indeed, **Manufacturing** managed to avoid contraction, with buoyant global demand for petrochemicals (production of which was rising rapidly) helping to support revenues even as prices of refined products fell in line with crude. By 1989, all sectors were back in positive territory with the exception of **Trade**, which was pulled down by a further fall in import spending.

Chart 5: Saudi Nominal Nonoil GDP by Sector, 1988-90
(percent change)



Oil prices rebounded forcefully in 1990, giving a lift to Manufacturing

Construction remained subdued as public sector capital spending was reined back

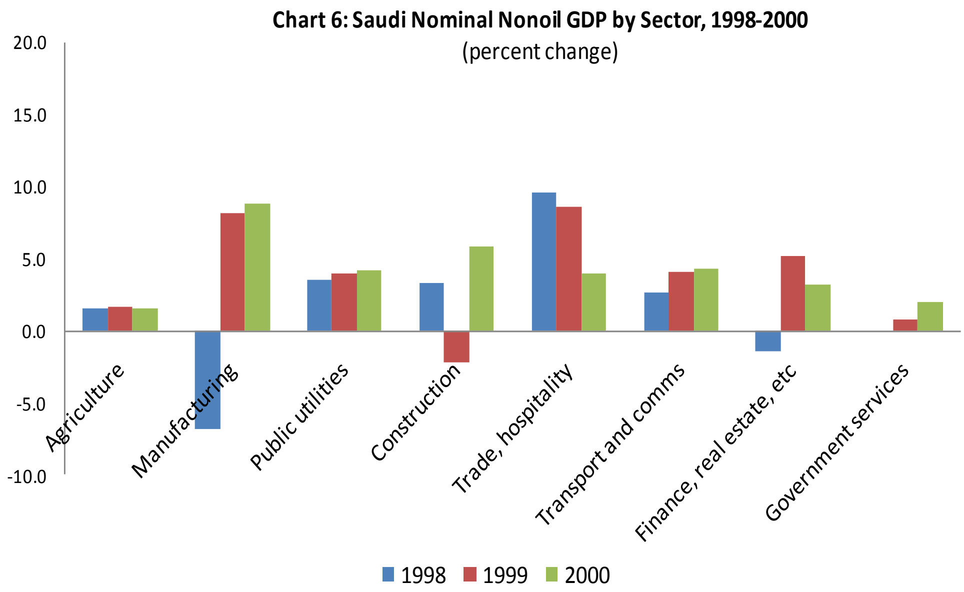
The upturn in oil prices in 1990 was quickly registered in a number of sectors, including **Manufacturing**, which benefitted from higher prices for refined products, and **Trade** and **Transport**, which was boosted by a 14 percent pickup in import spending. Despite the comparatively positive story, it is worth noting that both **Public utilities** and **Construction** posted only weak growth over the period. Public investment had been very strong for the first half of the 1980s (too strong many would say) and with the oil price collapse in 1986 the authorities took the opportunity to rein back capital spending quite sharply. Thus, investment in utilities and other areas of infrastructure remained subdued even after oil prices recovered in 1990.

1998

The 1998 recession saw a more even performance

The most striking feature of the 1998 slump is that the overall performance was much more even—both across sectors and years—than in the two previous periods. This is partly explained by the 43 percent rebound in oil prices in 1999, which helped confidence to recover fairly quickly, while also giving a boost to **Manufacturing**. It also reflects the fact that government spending was cut by only 17 percent in the crisis year, compared to around 25 percent in both 1986 and 1988. Indeed, capital spending was increased quite sharply in 1998, giving a direct boost to **Utilities** and indirect support to **Trade** and **Transport**. Trade was also supported by an unexpected pickup in retail spending (as measured by points of sale transactions) which actually increased by 22 percent in 1998.

As in previous episodes, **Construction** lagged the general recovery, and in fact only fell into recession in 1999, just as oil prices were recovering. Nevertheless, the sector's eventual rebound, in 2000, was a strong one. **Government services**, meanwhile, mirrored the direction of current spending and performed poorly.



Over the three periods, Manufacturing and Agriculture have tended to outperform, while Construction and Finance have tended to lag

Drawing these different periods together, we can see that **Agriculture**, and **Manufacturing** have tended to perform better than other sectors, particularly during the first two periods under consideration. **Construction**, **Trade** and **Transport** all fared poorly in the first two periods, but the latter two gave a more vigorous performance in 1998, thanks largely to the pickup in government capital spending. **Finance** has tended to underperform, though its showing in 1990 was above average.

3. Current Period

The current recession has been marked by the government's aggressive counter-cyclical stance

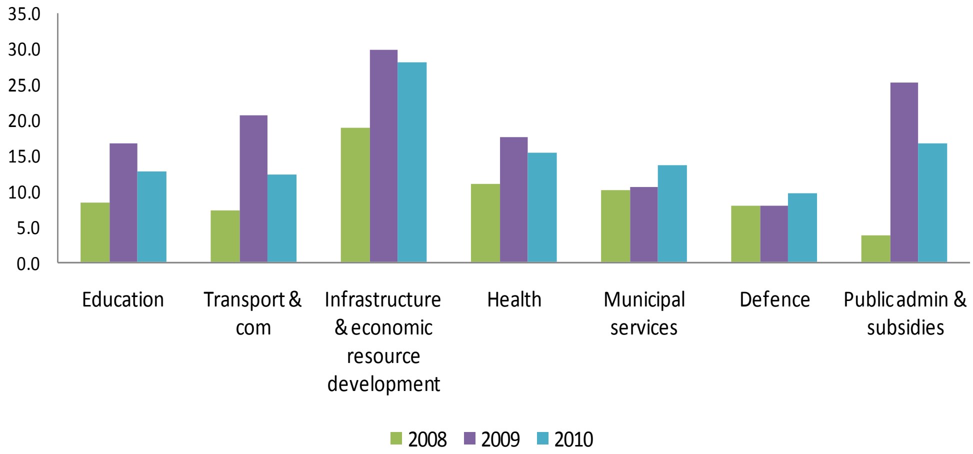
What of the current situation? The peak-to-trough decline in oil prices in 2008-09 was the most severe of any of the periods under consideration. But against this, the rebound in prices in 2009-10 has been more vigorous than previous episodes. In addition, the counter-cyclical response of the authorities has also been much more robust (overall spending has increased significantly). Data detailing the exact increase in spending are not yet available, but budgetary allocations can be used as a proxy. Budgetary data also give a useful guide to which sectors are being favoured.

The public sector spending surge has been tilted towards wages & infrastructure

Chart 7 shows the percentage change in budget allocations for the past three years. One of the most striking features of the chart is the pronounced increase in spending in 2009 in all but two sectors. Particularly notable is the 25 percent rise in Public administration in 2009 (the bulk of which is made up of **wages and subsidies**). This surge highlights the authorities' determination to protect nationals from the impact of the global and domestic slowdown: the 2009 increase was equivalent to an additional SR19 billion, and a further SR16 billion hike is programmed for this year.

Chart 7 also highlights a surge in government spending on **infrastructure**: this includes not just power and water (listed as Infrastructure and economic resources) but also health, education and transport infrastructure.

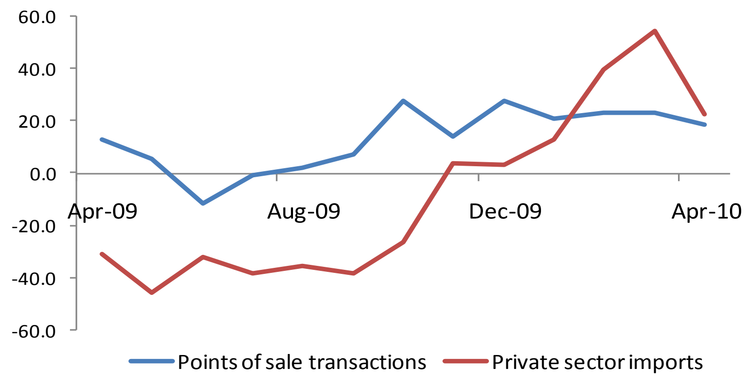
Chart 7: Saudi Budget Appropriations by Sector
2008-10
(percent change)



In response, Saudi households are consuming more

In 2009 the economic impact of this additional spending was limited: although public sector wages increased, Saudi households were content to build up savings. However, as confidence has improved, so households are beginning to save less and spend more. This has already given a decent fillip to **Trade**: points of sale transactions, which represent around 20 percent of retail sales, were up by more than 20 percent in the twelve months to April 2010, while private sector spending on imports grew by 19 percent.

Chart 8: Private Consumption Indicators
(12 month percent change)



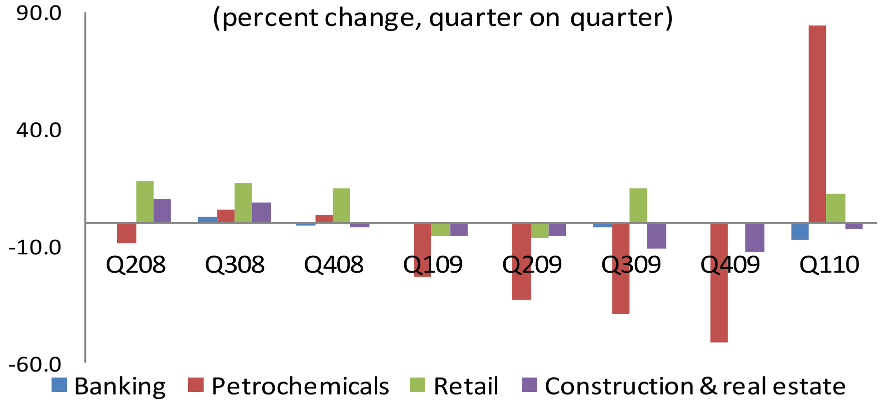
Retail firms listed on the stock exchange have done well

Although we have no GDP data, the impact of this spending can be gauged by the financial performance of those companies listed on the stock market, as detailed in **Chart 9**[1]. We can see the impact of the surge in government current spending from the performance of **Retail** firms. The retail sector, having experienced falling profits in the first half of 2009, returned to growth in the second half as consumers regained confidence.

[1] It is notable that with the exception of the Multi-investment and Insurance sectors, which we are not covering, none of the stock market sectors has recorded a loss during the current period

Chart 9: Net Profit of Listed Companies by Major GDP Sector

(percent change, quarter on quarter)



Construction firms have done less well, but the performance of listed firms does not tell the whole story

Against this, the P&L data also suggest that **Construction** firms have not performed particularly well, despite the enhanced budgetary allocations for infrastructure detailed in Chart 7. Indeed, the net income of construction firms has continued to trend down in 2010.

This underperformance fits with historical trends, but the data are somewhat misleading. The stock market's "Construction" index also includes a number of firms—such as pipe and cable manufacturers—whose profits are affected by the price of global commodities. They are mixed in with pure contracting firms, where domestic demand is the key factor. Given the volatility of global commodities' prices, the inclusion of these "auxiliary" firms tends to distort the overall performance of the Construction category. Moreover, anecdotal evidence suggests that *non-listed* contracting firms are enjoying a robust performance on the back of the public sector's investment surge.

Petrochemicals firms have bounced back strongly

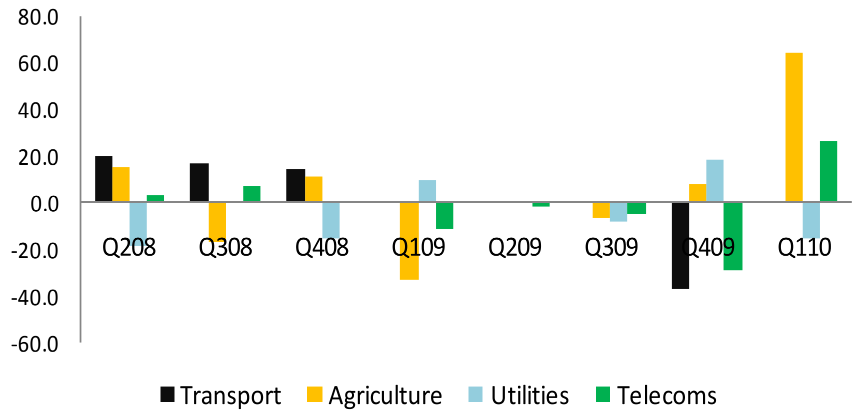
One sector where the performance has not been influenced by government spending is **Petrochemicals**. Buffeted by global currents, this sector's performance has been the most volatile. Profits plunged in 2009 as global economic activity stalled and demand for industrial chemicals deteriorated. This fits with the patterns from the earlier recessionary periods, where the downturn and subsequent rebound in energy prices had a direct and telling impact on the manufacturing sector. Similarly, as global demand—particularly from emerging markets—has recovered, so Saudi firms have seen their profits rebound.

The Banking sector's performance has been more measured

Notwithstanding the dislocations in global financial markets, the Saudi **Banking** sector remained largely untroubled during 2009 as demonstrated by very modest declines in profitability. In fact, the sector's net income position only worsened significantly in the first quarter of 2010, at a time when the other sectors saw their positions improve. The steady performance in 2009 largely reflected a strong showing from overseas investments, which offset sharply lower yields from domestic assets. The dip in profits in the first quarter of 2010 reflects increased provisioning in the wake of well-publicised debt problems among some major family conglomerates during 2009.

Chart 10: Net Profit of Listed Companies by Minor GDP Sector

(percent change, quarter on quarter)



Of the smaller sectors, Agriculture and Telecoms have recovered well

The performance of listed companies can also be used to gauge the recovery of smaller sectors of GDP, as depicted in **Chart 10**. **Transport** has lagged the recovery, recording its worst profit performance in the fourth quarter of 2009; this is somewhat surprising given its auxiliary role to Trade, which had recovered well before this, but might reflect dislocations in the domestic fuel market. **Agriculture**, which includes food production, processing and retailing (including restaurants) showed the strongest bounceback in the first quarter of this year, driven by higher sales and non-recurring capital gains from one of the two dominant players. **Telecoms** also recovered well following a difficult 2009, as discretionary spending on mobile phones picked up. The performance of **Utilities**—which is essentially the Saudi Electricity Company—has fluctuated, reflecting periods of substantial capital expenditure.

4. Outlook for Key Sectors

Manufacturing should perform well this year, though feedstock issues might hinder medium-term performance

What light do these various patterns shed on the outlook for different sectors? We noted earlier that Agriculture and Manufacturing rebounded quickly and forcefully from previous recessions, with **Manufacturing** leading the way. A similar pattern is emerging during the current period: petrochemicals demand has firmed and is likely to continue doing so as global industrial investment and production gain traction, while high oil prices should support yields in the refined products sector. The dominant Saudi petrochemicals producer, Sabic, is well placed to capture this recovering demand given its global marketing network and substantial gains in output due on stream this year.

The main constraint on the sector is the domestic scarcity of gas feedstock. Sabic is using its global reach to gain access to cheap gas in other countries, but smaller, private Saudi petrochems firms will have to hope that more domestic gas is unearthed, or move towards liquid feedstock—an expensive transition to make.

Within the Agriculture sector, vertically-integrated firms are leading the recovery

Agriculture is also replicating the pattern witnessed in previous periods, with a strong rebound in the profits of listed companies in the first quarter of 2010. Although government subsidies for wheat production are being withdrawn, the dominant listed firms in this sector, Almarai and Savola Group, are large, vertically-integrated conglomerates, with interests in retail and restaurants, as well as pure food production. Moreover, their interests in food production are focused on dairy and edible oils, rather than arable products. The performance of some of the smaller listed pure agricultural companies has been much less impressive.

Trade should recover strongly this year, with high-end retail likely to benefit from increased discretionary spending

The historical trends of the **Trade** sector are somewhat mixed, with a fairly weak response during the first two recessionary periods, contrasting with a vigorous showing in 1998-2000. As noted above, retail escaped the worst ravages of the 2009 recession owing to stepped-up government current spending. With oil prices back well above historical norms, and the stock market expected by many analysts to pick up again after a poor second quarter, discretionary spending is likely to increase, boosting the prospects for high-end retail in particular.

The outlook for **Construction** is not quite so clear-cut. We have seen how Construction has tended to suffer most during recessionary periods, and has remained in the doldrums even as other sectors have rebounded. Even during the 1998 recession, when the government ramped up capital spending, the sector did not respond positively until 2000. We also note the subdued performance of listed Construction firms, while also acknowledging that results have been skewed by the make-up of the index.

Despite its chequered history, Construction is well-placed for a solid performance in 2010-11

In general, and despite the historical precedents, we think the sector will perform strongly this year and next (a contention that is supported by the promising start to the year made by non-listed contracting firms). For a start, many of the public sector contracts that were awarded in 2009 are only now being rolled out. Second, with oil prices and confidence holding up reasonably well—despite recent concerns over Europe's high level of debt—a number of private projects might also be revived. Private construction would also be given a substantial boost if the mortgage law was approved, though we are not factoring this into our assumptions.

Banks' profits are likely to be under pressure this year

We have seen how **Finance** posted a comparatively poor performance during the first two recessionary periods, but fared much better in 1998-2000. The sector's performance in the current period has been more muted, with little deterioration during the height of the recession, but no sign yet of a rebound to growth. Judged on asset growth, the sector should perform better this year: banks are highly liquid and are looking to grow their loan books (albeit cautiously), while private sector demand for loans is gathering pace. A stronger stock market performance would also help to boost advisory income. Nevertheless, with abundant liquidity and growing competition, loan spreads are being squeezed again, and this is likely to weigh on profitability this year.

Keith Savard
Director of Economic Research
Keith.Savard@samba.com

James Reeve
Senior Economist
James.Reeve@samba.com

Andrew B. Gilmour
Senior Economist
Andrew.Gilmour@samba.com

Touheed Ahmed
Management Associate
Touheed.Ahmed@samba.com

Samba Financial Group
P.O. Box 833, Riyadh 11421
Saudi Arabia