Implementation is key in Saudi Arabia

The past week was historic for Saudi Arabia on multiple fronts: government announced an end to the ban on driving by women by mid-2018, tapped international market for $12.5 billion of debt issuance across different maturities, the largest by an Emerging Markets (EM) government this year, while the country also came closer to potential FTSE EM inclusion per FTSE annual country classification review. However, things weren't that rosy on the recent past economic indicators, with GDP contracting by 1 per cent in the second quarter, after a 0.5 per cent decline in the first quarter, and taking the country into a technical recession.

Also, foreign reserves shrank by $6.9 billion (a 1.4 per cent decline month-on-month and 9.2 per cent year-to-date) in August to $180 billion, lowest since early 2011.

Expert View

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Looking ahead, we expect Saudi Arabia to be likely included in FTSE EM in March 2018, and expect that the actual implementation could commence in September 2018. On the fiscal front, we expect further debt issuances by the government over the year to bridge deficit for the year (2017 guidance: $53 billion), in line with the government's guidance of increase in debt/GDP to up to 30 per cent by 2020, from our estimated 16 per cent currently.

The $12.5 billion ($3 billion with 5-year tenor, $5 billion at 10-year, $4.5 billion at 30-year) debt issuance was covered by over three times, and supported issuance at tighter yields than the initial guidance, and further underscores global appetite for regional bonds.

On the economic front, we see that tepid trend in the construction sector, with sector contracting by further 3.8 per cent in the second quarter, declining five times out of the past six quarters, reflect adversely on any imminent V-shaped recovery in the cement sector and we remain sellers of the sector.

The banking sector credit growth has been muted thus far, with lending increasing only by 1.3 per cent up to August (2015/2016: + 8.9 per cent, +2.8 per cent), and we expect credit growth to be low single-digit, at best. Amid banking sector outperformance (around 6 per cent YTD), we now see better value within petrochemical sector over banks. Amid some expected weakness on FTSE disappointment, we will look to increase exposure to National Petrochemicals Company (Petrochem) on improved product spreads, while add positions in Safco as a seasonal play on increased urea prices. We see insurance sector as the direct beneficiary of removal of ban on women driving, however, we are now less optimistic on the risk-reward proposition offered by the sector post significant outperformance (Saudi insurance sector returned 37 per cent in the past one-year), and prefer exposure to The Company for Cooperative Insurance (Tawuniya) within the sector.

Next review

The FTSE in its September Annual Country Classification Review announced that it will continue to keep Saudi Arabia in the watch-list for a potential inclusion in FTSE EM, first added on watch-list in September 2015, with a next review in March 2018. The delay in inclusion in FTSE EM is in line with our expectations but the overall narrative was very positive — specifically pertaining to changes in clearing and settlement and QFI registration process. FTSE mentioned that it awaits further enhancements to the Independent Custody Model (ICM), which are expected to be introduced in early 2018. We are optimistic on Saudi Arabia's inclusion into FTSE EM in March 2018, and in fact consider that actual implementation could commence in September 2018. Thus, in our view, announced delays in September inclusion in FTSE EM could pan out as a non-event. The government reiterated its plans to get Saudi Aramco listing in 2018, which further underscores the underlying broader market reforms in our view.

The cement sector stocks in Saudi Arabia have plummeted this year, with declines in the range of 13 per cent and 40 per cent, after the cement sector index returned a negative 34 per cent in 2015, followed by a decline of 5 per cent in 2016. This has translated into some market noises that the sector is ripe for building positions, specifically for attractive dividend yields.

In our view, yields look attractive with a rear view (2016 average yield for our coverage: 9 per cent), however, based on recent announced dividends we don't see much value — with first half 2017 annualised average yield of 4 per cent (ranging between 0 per cent and 10 per cent), and we don't expect dividend profile to improve in the second-half compared to the first-half, in general. Additionally, we still see limited reasons to be buyers due to: a) structural sector issue lingers — with sector cement inventories estimated at about 9.5 sales months, the highest ever, b) limited uptick expected in construction demand in the short-term, and c) potential further increase in fuel oil price — with expected increase in November along with broader energy reforms in Saudi Arabia.

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