

The bullish case for Saudi equities

Matein Khalid argues that the Saudi equity market is where every investor should now invest his or her money.

Saudi Arabia is unquestionably the most compelling macro story in the GCC at a time when systemic debt issues cloud the prospect of UAE and Kuwaiti equities while Oman and Bahrain remain illiquid, non-index alternatives for global fund managers. The Saudi GDP is US\$430 billion, the largest in the Arab world. SAMA's hard currency reserves and foreign assets exceed US\$500 billion. The Saudi public debt is a minuscule 14 per cent of GDP, a testament to the Kingdom's conservative use of its petrodollar export windfall in the past decade.

The largest, youngest population in the GCC means an exceptional secular opportunity for the growth of service, retail, mortgage finance, insurance, mobile telecoms and commercial bank companies. King Abdullah's reformist agenda coincides with US\$80 crude oil and the most ambitious infrastructure and economic development program in the Middle East. Riyadh's Capital Market Authority intends to open up the biggest investment banking and asset management market in the Gulf to foreign investors, banks and brokers. Saudi Arabia has introduced a mortgage law and insurance law and has established six economic cities that could well reshape the industrial constellation of the Middle East. A cash-rich government, a banking system so flush with liquidity that loan-to-deposit ratios are the lowest in the Gulf, a vigilant and prudent central bank, a commitment to attract FDI on a global scale into the economic cities, a low public debt and the cheapest, largest crude oil reserves on the planet make Saudi Arabia potentially the most attractive secular equities market in the Arab world.

Saudi Arabia's Saudi Aramco, worth a trillion dollars, is not listed on the local stock exchange, but investors can find exceptional growth opportunities in Saudi Arabia after an epic, vicious bear market during which the bellwether Tadawul index lost two-thirds of its value.

Catalysts for bull market

There are several catalysts I envisage to kick-start a bull market in Saudi equities. One, crude oil prices could well break out from their recent US\$68-80 range in West Texas Intermediate, particularly as OPEC quota supply discipline is coupled with higher petroleum products demand as global economic growth accelerates. Saudi Arabia is the largest exporter of crude oil and also the swing producer, the central bank of black gold in OPEC.

Two, the six economic cities are expected to be home to five million people, host a million new jobs and double the per capita income GDP in the Kingdom. The economic cities are a decade-long project, but they promise an industrial, entrepreneurial future for a desert Kingdom whose economic transformation began with the discovery of oil in Dammam seven decades ago.

Three, Saudi private sector credit and M2 have bottomed and have started to rise. Four, the Saudi budget was expansive and offset the contraction in oil production, consumer and construction spending. The Saudi government initiated classic counter cyclical fiscal measures once championed by Lord Keynes during the Great Depression in the 1930s.

Five, the Al Gosaibi-Saad Group debt shock and collapse of the Dubai property market (where many Saudis were investors) triggered a classic credit crunch in the Kingdom, raising concern about

bank balance sheets and cash strapped major conglomerates. Credit growth naturally collapsed in 2008-2009, but it is now increasingly evident that bank loan growth has turned positive again. Saudi Arabia is neither Greece nor Dubai.

Six, Saudi Arabia now trades at a reasonable valuation of 13 times earnings and 2.5 times book value, a fraction of the bull market bubble peak in the Tadawul four years ago. Saudi equities are not dirt cheap at 6800, but also are not as expensive as they were when the Tadawul flirted with 20,000 in early 2006.

Saudi domestic themes

Saudi banking is the most liquid, least leveraged, least offshore funding dependent, highest loan growth potential segment of the Gulf-listed banking universe. However, the Saad-Gosaibi debt shock also demonstrates the sheer scale of the losses borne by their merchant family-owned corporate clients in the global property and equities markets.





Even though loan growth has now turned positive and Saudi GDP growth can be four to five per cent, I still do not recommend taking aggressive exposure on Saudi bank shares, since there is simply no guarantee that the provisioning cycle has peaked and corporate credit black swans can still devastate balance sheets. However, the most profitable, liquid and well-capitalised banks in the Kingdom remain Al Rajhi and SAMBA Financial, the former Citicorp outpost in the Kingdom. The Saudi corporate sector must deleverage as long as its disclosure, governance and corporate credit exposure metrics are so far below international standards. Moreover, net interest rate margins, government debt trading profits and investment products fee income will not turbo-charge bank earnings.

I am bullish on SABIC at this stage of the global business cycle. The IMF has just updated global GDP growth to 3.9 per cent. Petrochemical demand will only rise as Chinese, US, German, Indian and

South Korean industrial production rise. Meanwhile, Saudi mega projects are complete and capacity expansion will rise. The demand for Saudi steel is extremely strong, driven by infrastructure and construction projects. SABIC, after its epic acquisition of GE Plastics, means deal risk is no longer a sword of Damocles that could hit the share price. SABIC growth will be organic. SABIC is one of the most attractive petrochemical blue chip shares in the world. I can easily envisage SABIC trading as high as 120-130 Saudi riyals by the end of the year as margins rise and earnings growth accelerates, while the full impact of GE Plastics transforms its global corporate franchise.

I believe mobile telephony is another Saudi domestic growth theme in the years ahead. Data traffic and population growth will dominate wireless. While Saudi voice mobile penetration rates are mature (akin to Western Europe at 150 per cent), data and video is the growth catalyst. I prefer Mobily among Saudi Arabia's telecom,

as STC is a complex incumbent and Zain cannot expand its network with 15 billion riyals in debt. Mobily can easily expand earnings by 20-25 per cent and see its share price rise to SAR60-65.

Saudi Arabia's embryonic bull market could be hit by a number of macro risks. A collapse in oil prices would be catastrophe. King Abdullah and Crown Prince Sultan are both in their eighties, so any shifts in the royal succession will be bearish for Saudi equities. A global double-dip recession (an unlikely scenario) could hit oil prices, SAMA investment income and bank profits. A failure to attract foreign direct investment or financing for key projects like the King Abdullah Economic City would be negative for Saudi financial markets. However, the risk-reward calculus favours a bull market in Saudi equities.

HW

Opinions expressed in this article are those of the author and do not necessarily represent those of the MONEYworks group of magazines. This article should not be misconstrued as financial advice. Don't forget that investments can go down as well as up and you may not get back the amount originally invested.