Saudi business confidence slightly wavers
Executives optimistic, outlook positive

- Q3 2010 BSF Business Confidence Index falls to 99.8 points from 100.7 points in Q2 2010
- Almost all respondents foresee some domestic impact from Europe debt crisis in next two quarters
- Business leaders still optimistic, but more guarded about bank credit, oil prices, revenue, inventory growth than they were in Q2
- Respondents choose cash and bonds as their top investment picks in next two quarters, highlighting risk aversion

Greater global economic uncertainty in light of the euro-zone debt crisis and volatility in oil prices over the last two months has taken a toll on sentiment among Saudi business executives, who have adopted greater caution in their outlooks for financial performance, bank lending, investment strategies and hiring plans.

External circumstances have tempered optimism about the pace of economic recovery in the world’s top exporter of crude oil, although most respondents in Banque Saudi Fransi’s third-quarter (Q3) Business Confidence Index remain by and large confident about the growth potential for the domestic economy.

An overwhelming 98% of the 793 company managers surveyed said they expected Europe’s debt crisis would affect the Saudi economy and business climate in the next two quarters. However, only 23.7% said they thought the domestic implications of the euro-zone crisis would be “substantial”, while most, 74.5%, said any impact would be slight to moderate. As oil prices tumbled from levels above $80 a barrel in March and April and it became clear the global recovery could be more erratic than formerly presumed, company executives readjusted their own business strategies, the survey showed.
Overall BSF Business Confidence Index fell to 99.8 points in the third quarter from 100.7 points in the second quarter. The base value of 100 represents the third quarter of 2009. The survey, conducted quarterly, draws on the perspectives of top managers in finance, real estate and construction, information technology, petrochemicals, tourism, advertising and legal affairs. Respondents to the Q3 survey, conducted June 5 to June 13, highlighted the following standpoints about the prevailing business climate:

- With lower oil price expectations in mind, fewer businesses are confident that sales will improve in the coming two quarters. Some 53.8% of respondents think their organisation’s sales will rise during the period, down sharply from 88.6% who gave the same response in Q2. A good proportion of respondents, 35.8%, are betting on the status quo, with sales remaining the same in the next six months, up from only 3.5% who gave that answer in Q2.

- Business executives continue to hold a negative outlook on the prospects for bank lending in the coming two quarters, with 46.5% describing bank lending attitude as "not good", higher than the 41.5% who predicted the same in Q2. Still, more than a third of business leaders foresee bank lending returning to normal over the period.

- Risk aversion has gripped investors yet again, with 48% of business leaders ranking cash holdings as the best
medium-term investment prospect, ahead of bonds, real estate and equities. This is up sharply from 11.9% in the Q2 survey and is reflective of prevailing perceptions that prices of real estate and shares will most likely weaken or remain flat in the coming months.

$65 no longer a floor for oil prices

Business executives are more bearish than they were in the first and second quarters about where they see oil prices for the rest of the year. In the bank’s Q1 and Q2 surveys, none of the respondents saw oil prices falling below $65 a barrel. This attitude has shifted since oil prices per barrel dropped from the mid-$80 to the mid-$60 level in May on the heels of Greece’s debt troubles.

Some 35% of business leaders expect crude prices could weaken below $65 a barrel in the next two quarters, the survey showed. Even above $60 a barrel, Gulf energy exporters, including Saudi Arabia, are more or less able to balance their fiscal budgets, however prices above $70 a barrel are needed to support longer-term investment plans, particularly in boosting oil and gas capacity.

The biggest proportion of executives (45%) expect oil prices will range between $65-$75 a barrel in the forecast period, while only 20% expect prices will exceed $75 – which bodes well for Saudi Arabia’s stimulatory spending programme. The state has taken on the dominant role in financing strategic projects in the last year and a half. In the second quarter, a majority of respondents expected oil prices to range between $75-$80 a barrel.

With oil prices likely to hover below this range in the foreseeable future, business leaders have adjusted their company strategies and macro-economic expectations accordingly. The number of respondents who said they expected the Saudi economy’s performance would "much better" in the coming two quarters fell to 30%, from 74.5% in the Q2 survey. While a full 70% of respondents still expect economic conditions will be "better" or "much better", almost a third (30.3%) said economic circumstances would "remain the same".

Inflation, meanwhile, is seen accelerating in the coming two quarters. Some 49.3% of business leaders predict the inflation rate will rise (against 37.5% in Q2), while 34.4% said they thought inflation would fall (against 21.6% in Q2). Inflation climbed to a one-year high of 5.4% in May, predominately driven by higher food costs, while rental inflation rates continue to decline.

Return of vigilance

The more cautious external atmosphere has muted the expectations of executives about the performance of their businesses. While a majority of 53.8% of respondents expect company revenues to rise in the next to quarters, that...
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is down sharply from 88.6% who gave the same answer in the last survey. A greater number of executives – 35.8% – foresee revenues staying the same in the near future, compared with just 3.5% in Q2. Only 7.2% of respondents expect revenues will fall over the period.

Greater vigilance does not mean businesses are bearish, only that they are mindful that the global recovery is going to be bumpy rather than smooth. The domestic economy is well-shielded from any European contagion, both because of the government’s strong fiscal position and due to the country’s greater reliance on Asia. Reflecting this, all respondents said they expect their companies’ financial performance to either stay the same or improve in the coming six months.

A slight majority of 53% business leaders foresee stronger financial growth for their companies over the period, down from 62.4% in Q2. A greater number of respondents said they expected growth to stay the same (46.8% in Q3 versus 37.6% in Q2).

In keeping with this cautious attitude, almost a third (31.9%) of executives said they planned to lower prices in the next two quarters (against 16.8% in Q2). The biggest proportion of respondents (49.7%) said they would hold prices steady over the period, while only 18.4% said they would opt to raise prices (against 28.7% in Q2).

Expecting a dip in consumer demand and more subdued
trade flows, businesses are on the whole not looking to boost inventories in the coming six months. Only 13.5% of respondents said they would raise the level of their inventories over the period, down sharply from 49.8% in Q2 and 33.7% in Q1. The most-likely scenario is that after replenishing inventories for the last two quarters, businesses would look to decrease them slightly as they adjust to slower economic conditions. Some 40.1% of businesspeople gave that answer (against 22.2% in Q2), while almost a third of respondents will continue to keep inventory levels steady, slightly higher than Q2.

The slower business environment is not likely to undermine company investments in capacity expansion, however. Most business leaders, 53.8%, said they would increase production capacity in the next two quarters (against 51.6% in Q2). Still, many businesses are on their guard –19.5% said they would decrease production capacity (against 10.8% in Q2). Some 26.6% said they would keep capacity levels steady (against 37.6% in Q2).

Uncertainty has also filtered into company employment strategies, the survey showed. While none of the respondents expected to let go of staff in the coming six months, the proportion who said their companies’ would implement a freeze on new hiring rose to 27% from 10.4% in Q2.

A strong 48.9% of business executives expect to hire new employees in the period (down from 61.2% in Q2). This upbeat employment attitude is largely a reflection of robust fundamentals in the domestic economy, where the government is spending heavily to ensure that key infrastructure projects proceed with little hindrance despite continued tight credit conditions.

**Bank lending not out of the woods**

The lending attitude of banks has been and will continue to improve at a lethargic pace, according to respondents, whose perspectives on the potential for bank credit accessibility worsened slightly for Q3 compared with Q2. The biggest proportion of business leaders, 46.5%,
described banks' lending attitude as "not good", higher than the 41.5% who answered the same in Q2.

Bank lending to the private sector has been rising slowly, with annual claims on the private sector growing 3.2% in April, the highest annual growth rate in eight months – but still a far cry from peaks exceeding 30% in 2008. While normalcy is beginning to return to bank lending after a stagnant 2009, improvements will continue to follow a very slow pace, survey results indicated. Some 34.2% of respondents said banks' lending attitude would return to "normal" in the next two quarters (against 33.1% in Q2), while the number of executives describing banks' lending outlook as "very good" or "excellent" stood at 19.2% in the survey, down from 25.4% in Q2.

Executives have overwhelmingly noticed the greater risk aversion adopted by Saudi banks, which have implemented more stringent policies vis-à-vis granting loans to long-standing family businesses. A firm majority, 63.8%, of company managers said banks had tightened requirements for loan approvals to businesses and households "substantially" in the past year. That marked a brusque rise from 36% giving the same response in Q2.

Of the remaining respondents, 24.5% said banks lending requirements had been tightened "noticeably but not substantially", while 11.7% said changes in credit criteria were only slight. Traditional relationship lending practices were challenged last year following the debt troubles of two family conglomerates, which shocked a banking system already caught in the wave of global risk aversion. Banks implemented revisions to relationship lending policies to make them more rigorous.

Still, with credit growth conditions better than they were last year and in the first quarter, many business leaders are not ruling out an increase in interest rates in the next two quarters, with 36.7% expecting rates to rise by more than 10 basis points (against 24.7% in Q2) and 14.8% expecting hikes of more than 20 basis points (against 13.7% in Q2). Almost a third of respondents still think rates will stay the same, on par with the last quarter's showing.

**Equities, real estate fall out of favour**

Volatility on global and regional equity markets in the last two months has distressed business executives who, after shunning stock market investments during 2009, began to re-direct funds into shares in the first part of 2010. The tables have turned again, according to the survey. Only 21.3% of respondents said they expected the stock market would witness "positive" performance in the next two quarters, down a great deal from 41.7% in Q2.

Reflecting the uncertainty that prevails, the most common response to a question about how equity markets would perform was "not sure". Some 38.3% of executives gave
that answer (against 16.4% in Q2), while almost a third (30.1%) expect markets will be flat. Only 10.2% said they expected share prices would fall in the near-term (against 7.4% in Q2). By the end of May, the Tadawul index had dropped more than 13% from a 19-month high on April 24, prior to the escalation of the euro-zone debt crisis.

A good deal of investor uncertainty has stemmed from the volatility in oil prices and insecurity about global demand for Saudi crude and chemicals. Among equity sectors, petrochemicals has fallen out of favour among businesspeople, with only 15.9% of respondents listing petrochemicals as their most-preferred equity sector for the next two quarters (against 28.6% in Q2 and 47.7% in Q1). Businesspeople see greater upside potential in telecommunications shares, with 36.9% listing that sector as their top pick (against 23.8% in Q2). Banks were still regarded by a firm 31.7% of respondents as the top equity pick, up from 27.9% in Q2, the survey showed.

Negative sentiment has also hit the real estate sector. An overwhelming 61.3% of business leaders expect real estate prices will fall in the next two quarters, up substantially from 31.9% who forecast the same in Q2. The share of respondents who predict real estate prices will rise in the next six months fell to 14.8% in Q3 (against 24.7% in Q2), while 17.9% said they anticipate prices would remain steady (down from 30.4% in Q2).
Cash is king

Restrained expectations for real estate and stock market performance in the coming period has taken its toll on the upcoming investment preferences of business leaders, the survey showed. Companies would rather park their capital in low-yielding, low-risk investments until uncertainty eases, executives said.

Asked which single asset class would provide the best returns in the next two quarters, 48% of business leaders ranked holding cash above bonds, real estate and equities – up sharply from 11.9% in the Q2 survey. Cash overtook real estate as the top investment pick for businesses, followed by bonds, which got 21.7% of the votes (against a low 4.6% in Q2).

The share of respondents who thought equity and real estate investments would yield the best returns was slashed to 15.4% for equities (against 41.1% in Q2) and 14.9% for real estate (against 42.4% in Q2) – underpinning the drastic shift in risk aversion adopted by regional investors.
Analysis

The fragility of the global economic recovery evidenced in Europe's debt crisis in many ways served as a reality check for Saudi business executives. Company managers revealed in the Q3 2010 BSF Business Confidence Index that they are more guarded now than they had been prior to the euro-zone sovereign debt crisis about the resilience and pace of the country's economic recovery.

Oil price volatility has been the most-potent risk related to the European debt crisis for Saudi Arabia. As we have argued in the past, we do not foresee the Saudi banking system or the dollar-pegged riyal currency facing any systemic risks as a result of Europe-wide contagion. The system's overall capital adequacy ratio, at about 16%, far exceeds the minimum regulatory requirement of 8%, and reported nonperforming loans are around 3.2% of total loans which is low as per global standards. Almost a third of Saudi Arabia's 2009 imports came from Europe, while Saudi exports to Europe more than tripled between 2003 and 2008. Still, Asia has taken over in recent years as a predominant trading partner, now accounting for 55% of exports, compared with Europe's 10.5%. As China's central bank embarks on greater “flexibility” in its currency, a stronger yuan will boost the purchasing power of households in China which could translate eventually, although not immediately, into higher demand for Saudi oil and non-oil products.

We have reduced our forecast for oil sector GDP growth in 2010 to 3.7% from 4.1%. We also trimmed our average oil price forecast for 2010 to $76 a barrel from $78 earlier, compelling us to cut our current account and fiscal surplus estimates for the year.

Despite these slight revisions, Saudi Arabia is on strong fiscal footing – it is likely to pay down domestic debt to 13% of GDP in 2010 (from 16% last year) and holds SR1.55 trillion ($413 billion) in net foreign assets, giving it a very comfortable cushion to draw on to finance its expansion. The results of the survey are consistent with this perspective – while business leaders are more wary, they are still overwhelmingly positive about the financial prospects for their businesses and for the economy at large. Most still expect to see revenue and sales growth, and a majority are planning to boost production capacity. Undoubtedly the overall corporate and macroeconomic picture is more optimistic compared to a year ago. This leads us to expect steady and sustainable growth for the rest of the year for corporations and the economy in general.

We have raised our forecast for government sector GDP growth to 4.6% for 2010, a 13-year high, while the private sector is set to expand 3.7% in real terms this year. A lot of this expansion will, however, be financed through a combination of government funds and working capital that private businesses had accumulated during the boom years. As the survey revealed, it will take some time before banks really accelerate the pace of new loan growth. Business leaders are overwhelmingly downbeat about the prospects for bank lending, which we regard as a key hurdle facing a well-rounded economic recovery in Saudi Arabia.

The shift toward risk aversion in investments was also striking in the survey results. Business leaders indicated that holding cash would offer the best returns in the next six months as stock prices face an uncertain direction and real estate prices fall. Investors in regional markets will need to see oil prices stabilise above $70 a barrel and stability on global markets in order to reassess their level of risk aversion in the coming months. The passage of an imminent mortgage law, while it will take a long time in practice to implement, is also likely to catalyse interest in Saudi real estate in the medium term.
About the survey

The BSF Index attempts to gauge market sentiment on a quarterly basis, using a comprehensive survey conducted by the bank. The Q3 2010 survey was carried out June 5 to June 13, based on a sample of 793 respondents in companies in a variety of sectors. The respondents are representative of all three main business regions in the country – with 36% from the Central Region, 31% from the Eastern Region and 33% from the Western Region.

Methodology

We used the following formula to calculate the overall index level. \( \text{Index} = \sum w \cdot D_i / (\text{base value XX} = 100) \); where \( w \) is weight, \( D_i \) is net balance of question \( i \). Weights are assigned to each of the survey questions we use in the Index. Please note that, for balance, responses of a subjective nature have been eliminated when preparing the diffusion index.

The BSF Business Confidence Index has a base value of 100, which corresponds with the third quarter of 2009. Higher scores indicate a positive result, while scores below 100 demonstrate that business confidence is on a falling trend.

Industries surveyed

- Advertising: 7.6%
- Construction: 25.3%
- Financial institutions: 10.1%
- Information technology: 7.6%
- Law offices: 5.1%
- Petrochemicals: 7.6%
- Real estate: 21.5%
- Tourism: 15.2%

Respondent profiles

- Chairmen: 31.7%
- CEOs: 27.8%
- Vice-presidents: 22.8%
- Middle managers: 10.1%
- Junior managers: 7.6%

Additional support provided by the Gulf Research Center (GRC).
Disclosure appendix

Analyst certification

The analyst(s), who is primarily responsible for this report, certifies that the opinion(s) on the subject security(ies) or issuer(s) and any other views or forecasts expressed herein accurately reflect their personal views and that no part of their compensation, was, is or will be directly related to the specific recommendations or views contained in this research report.

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Additional disclosures

1 - This report is dated as at 22 June 2010.
2 - All market data included in this report are dated as at close 21 June 2010, unless otherwise indicated in this report.
3 - Banque Saudi Fransi has procedures to identify and manage any potential conflicts of interest that arise in connection with its Research business. A Chinese Wall is in place between the Investment Banking and Research businesses to ensure that any confidential and/or price-sensitive information is handled in an appropriate manner.

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