Saudi Q4 business confidence recuperates
Managers watchfully positive on revenue, lending outlook

- Q4 2010 BSF Business Confidence Index rises to 100.2 points from 99.8 points in Q3 2010, although still lower than Q2 results
- Managers see oil prices ranging $75-$85 in next two quarters, supporting macro-economic outlook and better revenues
- Business leaders are more optimistic about bank credit revival than at any point this year, although improvement seen gradual
- Executives return to risk, abandon cash and bonds in favour of equities and real estate as top investment picks in next six months

Strong and steady oil prices in the third quarter and an upturn in domestic consumer demand led to a renewal in positive sentiment among Saudi Arabia’s business leaders who, while they remain wary, are taking more risks with investments and expecting higher revenues to come.

Most of the 881 respondents to Banque Saudi Fransi’s fourth-quarter (Q4) business confidence survey expect the economy will move further toward recovery over the next two quarters. Company executives have mainly set aside concerns over the euro-zone debt crisis that had hurt sentiment in the Q3 survey. They plan to increase production capacity, build inventories and hire new staff, survey results showed.
Evidence that bank credit momentum is building helped lift the overall BSF business confidence index to 100.2 points in Q4 from 99.8 points in Q3. 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 Q4 survey, conducted Sept. 25 to Oct. 9, brought to light the following themes:

- Steady or higher oil price outlooks among businesses underpin confidence that revenues will improve in the next two quarters. A firm 66.2% of respondents expect their company’s revenues will rise during the period, up from 53.8% in the third quarter. This is still vastly below the 88.6% who responded the same in Q2, highlighting a continued sense of hesitation. Some 28.6% of respondents are still anticipating that sales volumes will hold steady in the next six months, down from 35.8% in Q3 and 3.5% in Q2.

- Business executives are witnessing a gradual improvement in credit markets; some 21% of respondents described banks’ lending attitude as “not good” in the Q4 survey, far fewer than the 46.5% who forecast the same in Q3. The largest proportion of executives, 43.5%, expect bank lending will be “normal” over the period, while more than a third thought it would be very good or excellent.

- Investors are more comfortable taking risks with their surplus cash than they were in Q3. The ratio of business leaders who described cash holdings as the best medium-term investment prospect fell sharply to 9.3% in Q4 from nearly half of respondents in Q3. Equities gained favour with 43.9% of the votes, followed by real estate, bonds and cash. This is backed by perceptions of improved real estate prices and more positive performance in shares.

Oil price stability colours economic optimism

An average oil price of more than $76 a barrel in Q3, in addition to continued stronger demand from clients in Asia, has sharply changed the energy outlook espoused by Saudi businesspeople in the Q4 survey.

In the last survey, more than a third of respondents thought oil prices would fall below $65 a barrel in the following months and the vast majority expected prices would fail to rise above $75. Contrary to expectations, however, not once in Q3 did prices fall below $70, a fact that has emboldened executives’ oil market outlook. Only 2% of respondents (against 35% in Q3) expect crude prices will drop below a floor of $65 in the coming two quarters, with 75% assuming prices will range between $75 and $85 a barrel.

This is promising for the state’s fiscal revenues, more than 85% of which are derived from oil exports, and should enable the kingdom to sustain foreign asset holdings at
about 100% of GDP while supporting an expansionary spending programme. Net foreign assets held by the Saudi Arabian Monetary Agency (SAMA) are 10-fold the level they were in 2002.

Resilient oil prices have heightened the expected pace of recovery of the Saudi economy. An overwhelming 90.4% of respondents said they expected “better” or “much better” macro-economic performance in the next six months, up from 69.7% who said the same in Q3. While the answers were still weaker than Q2, they support expectations of a turnaround in economic growth. We expect GDP growth will rise to 3.8% this year and 4.2% in 2011, from 0.6% in 2009. The number of respondents anticipating an economic status quo dropped to 9.6% from almost a third in the last survey.

Hand-in-hand with a revival in domestic demand and output is the acceleration of inflation, which topped 6.1% in August and slightly dropped in September to 5.9%, the highest rates in the Gulf region. Expectations for steeper rates of inflation have steadily risen in the past three quarters. A majority of business leaders (57%) predict the inflation rate will rise in the next six months (against 49.3% in Q3 and 37.5% in Q2), while 14.5% said they thought inflation would stay at the same level.

A decent ratio of managers, meanwhile, foresee downward
pressure on prices in the coming months, with 28.5% saying they expect inflation to fall (against 34.4% in Q3). Driven by steep food prices and rents, and escalating goods and services costs, inflation in the kingdom has few easy fixes using monetary policy. Money supply is still relatively low to contribute to inflationary pressures. None of the respondents expect a change in the dollar-pegged currency regime policy in the next six months, while a majority of 55.5% project interest rates on loans will remain steady (against 31.3% in Q3).

**Companies foresee better sales, plan hiring**

The survey corroborates anecdotal evidence of a pickup in domestic demand; a greater proportion of executives expect stronger revenues for their businesses during the forecast period. Over the next six months, 66.2% of Saudi firms are forecasting greater sales (against 53.8% in Q3), while 28.6% think revenues will stay the same (down from 35.8% in Q3). Only a slight 3.6% of respondents expect revenues to fall.

A signal that firms are striving to remain competitive, the bulk of respondents (54.6%) plan to keep prices for their goods and services the same in the next two quarters – that’s up from 49.7% who said the same in Q3 and is higher than any other point this year. A fifth of respondents plan to raise prices (steady from 18.4% in Q3) while a quarter are going to lower them (down from 31.9% in Q3), the survey showed. For the next six months, slightly fewer company managers than in the Q3 survey (51.4% versus 53.2%) anticipate stronger bottom-line performance.

Fluctuations in the performance of the global economy as well as volatility in oil prices would have implications on consumer demand at home. As a result, respondents are vigilant with regard to the extent to which they plan to replenish inventories of goods. Some 37.2% of business leaders plan to raise inventory levels in the next two quarters, up sharply from 13.5% in Q3. But a majority of companies are still either planning to reduce inventories (31.3%) or keep them at the same level they are now (22.2%). In the second quarter, half of respondents had
plans to boost inventories, again underpinning the qualms managers have about the firmness of the recovery.

Misgivings aside, companies plan to continue to invest in building capacity for the longer term. A majority of business leaders, 57%, said they would increase production capacity in the next two quarters (against 53.8% in Q3). The ratio of respondents who would reduce production capacity fell to 10.2% in Q4 from almost 20% in Q3. Meanwhile, 32.8% of companies are holding back on investments and keeping capacity as it is (against 26.6% in Q3).

A firmer economic backdrop has added impetus to company recruitment plans, which had wavered in the Q3 survey. The proportion of respondents who said they would hire new employees in the next six months rose to 54.9% in Q4 from 48.9% in Q3. That is still lower than the 61% who planned recruitment drives in Q2 but illustrates that the private sector labour market is set for a revival following a stagnant 2009.

There is a long way to go, however, in jumpstarting the job market. The number of respondents who indicated they would put a freeze on new hiring climbed to 34.2% from 27% in Q3, although none of the companies surveyed said they planned any layoffs.

Bank lending outlook best of the year

Reinforcing the pace of bank credit growth remains a key challenge for the Saudi banking system, although sentiment on the outlook for loan accessibility has improved markedly from the first three quarters of the year. The proportion of business leaders to describe banks’ lending attitude as “not good” fell sharply to 21% in Q4 from 46.5% in Q3. That also marks a substantial decline from almost 60% of executives who were disappointed with the bank lending outlook in Q1.

The shift in sentiment has happened in tandem with the modest credit recovery that is taking place in the kingdom. Growth in bank claims on the private sector stood at 3.3% in August compared with no growth in December. Credit growth rates remain muted when compared with double-digit levels recorded in 2007 through to early 2009. Banks continue to be vigilant in granting new loans, although the credit scenario is likely to recuperate into 2011 as a greater volume of project financing deals comes on stream.

In the fourth quarter, the largest proportion of respondents, 43.5%, said they expected the lending attitude of banks to be “normal” in the next six months (against 34.2% in Q3), while 11.5% described their outlook for bank lending as “excellent”, more than double the percentage that gave the same answer in Q3.
Still, banks have been tightening lending requirements and making it more difficult for businesses and individuals to get loans, the survey showed. A strong majority of 68% of company managers said banks had tightened requirements for loan approvals to businesses and households “substantially” in the past year (up from 63.8% in Q3). It appears banks could be getting more strict with policies because in the Q2 survey, only 36% of respondents had given the same answer.

Risk appetite makes a small comeback

Less volatility in equity markets in the third quarter contributed to a return in risk appetite in the Q4 survey. Saudi Arabia’s main index, Tadawul, rose almost 6% in the three months to Sept. 30, having dropped almost 11% in Q2. The positive performance, which has continued into October, is guiding business sentiment regarding potential investments.

Managers indicated a greater propensity for risk when asked which single asset class they expected would provide the best medium-term investment returns. The ratio of business leaders who described cash holdings as the top investment prospect fell sharply to 9.3% in Q4 from nearly half of respondents in Q3. Companies would rather park their capital in higher-yielding, more risky investments. Equities took 43.9% of the votes (against 15.4% in Q3),
while the ratio of votes for real estate advanced to 35.9% from 14.9%. However, the local stock market is still characterised by seasonally low volumes. Bonds and cash trailed far behind at 10.9% and 9.3% of the tally.

The change in risk attitude corresponds with a rise in the number of survey respondents who expect the stock market will gain ground in the coming two quarters. Managers giving that answer climbed to 34.5% in Q4 from 21.3% in Q3. While 9.9% project declines in equity markets (almost on par with Q3), 27.4% anticipate little change in share values over the forecast period. A good proportion of respondents (28.2%) are also uncertain what will happen, responding “not sure” to the question.

Banking and petrochemical shares swung back in favour among investors, according to survey respondents – 87% of whom cited the two sectors as their most-preferred in the next two quarters, a jump from 47.6% in Q3. The banking sector index in Saudi Arabia, which had fallen 9.7% in Q2, regained 6.6% during the third quarter, with positive prospects ahead as banks are expected to take less-aggressive provisioning against potential bad debt in the coming quarters. Some 45.5% of respondents cited banking as their top equity pick, followed closely by petrochemicals at 41.6%.

Global demand for petrochemicals and their market prices mirror the oil market closely. Expectations of better demand from Asia, in addition to higher oil prices generally, sup-
ported petrochemical stocks during Q3. Saudi petrochemicals shares, which had slumped almost 14% in Q2, since regained 8% during the July-September quarter.

Risk taking also contributed to a dramatic shift in the number of respondents who named telecommunications as their top equity pick. Telecommunications stocks also gained 7% in Q3 after falling more than 13% in Q2. Investors tend to prefer some telecom shares during periods of uncertainty due to their retail growth patterns. In the Q4 survey, only 6.7% of managers chose telecoms as their best equity market bet, down sharply from 36.9% in Q3.

Positive sentiment also returned vis-à-vis real estate prices. The number of business leaders who expect real estate prices to fall in the coming two quarters fell substantially to 37.1% in Q4 from 61.3% in the Q3 survey. In fact, the ratio of managers who expect an upturn in property prices was the highest since the first quarter at 38%. In Q3, only 14.8% of respondents thought prices would rise, which supports anecdotal evidence of mounting pressure on house prices toward the end of this year.

There is also evidence that commercial real estate prices are sliding and could continue to do so due to oversupply. Another factor accounting for the decline in commercial property prices could be the limited takers willing to pay rents at prevailing prices. Some 17.8% of executives polled foresee stagnancy in real estate prices in the coming period, on par with Q3.
Analysis

A renewal in business confidence in Q4 illustrates how closely executives in Saudi Arabia track global developments when creating their business plans. In the last three months, oil price buoyancy, a revival in global markets and a somewhat optimistic rise in local equities again put business confidence on an upward track following the Q3 dip. The Q3 survey highlighted how quickly business leaders react to global turmoil such as the euro-zone debt crisis, underpinning the fragility of domestic business sentiment. Uncertainty about the strength of the global economic recovery will continue to guide business planning in the kingdom and managers will watch what happens to global economic growth, the price of oil, currency volatility and especially a weakening dollar.

While optimism about revenues, production, investments, bank credit potential and the general macro-economic environment have returned in the Q4 survey, there is still tendency among executives to err on the side of caution. Company managers are not as bullish on their business prospects as they were prior to the euro-zone bailout announcement in May. Not as many of them plan to boost inventories and the number of respondents who intend to freeze prices in the next six months was the highest than any other point this year. More companies than in Q3 are also keeping a freeze on new recruitment. These factors combined signify the prevalence of hesitation in the business community. Businesses are as wary about investing as banks are hesitant to lend. It is only the government that is stepping up to the plate and channelling funds into the economy.

On the whole, however, business executives are aware of the fundamental differences that make Saudi Arabia a more sound investment bet than its neighbours in the region and its peers in the G20. The amount of external debt held by Saudi Arabia as a percentage of GDP is 22.3% this year according to the IMF, much lower than 55% in the UAE, almost 90% in Qatar and almost 140% in Bahrain. Investors are, hence, less likely than elsewhere in the Gulf to be concerned about possible sovereign or corporate debt defaults in the kingdom.

The domestic demand scenario in the kingdom is also comparatively strong with a population exceeding 27 million. Saudi Arabia continues to suffer from an undersupply of housing, evidenced in continued high rental inflation. The government, in its 2010-2014 development plan, is targeting construction of one million housing units to meet demand. Housing supply pressures explain the viewpoint of a good proportion of managers that real estate prices are poised to climb in the coming months.

Banks, meanwhile, are very liquid despite their hesitation toward granting new loans. It is a matter of time until banks resume lending at a faster pace. Once a catalyst, such as a greater pipeline of solid project financing deals, comes into play, credit growth rates are likely to accelerate. This could partly explain why there was a sharp improvement in confidence about the outlook for bank credit in the next six months, in addition to optimism on the direction of banking shares.

A key challenge facing the kingdom is job creation. Saudi Arabia’s unemployment rate rose to 10.5% in 2009 from 9.8% in 2008 – and we are not expecting this rate will ease in the next two years, although the government has ambitious plans to reduce the unemployment rate to 5.5% by 2014, mainly through a surge in private sector job creation. Resolving labour market constraints by providing better quality education to Saudi nationals is crucial so they are able to reduce the need to recruit skilled professionals from abroad. The government is making tremendous efforts toward upgrading the skills of its youth. Education initiatives, as well as nurturing the private sector to enable it to create an adequate number of new employment opportunities, are among the most crucial development objectives on the government’s plate.

The government has been willing to support the economy until a revival in private sector engagement takes place by bearing the burden of financing a lot of key projects in energy, transportation and utilities. It is not a surprise, then, that none of the respondents to the survey expect the macro-economic climate in Saudi Arabia to worsen in the medium term – oil prices are seen between $75-$85 a barrel, supporting continued growth of foreign assets, and creating a solid environment for businesses to operate in.
About the survey
The BSF Index attempts to gauge market sentiment on a quarterly basis, using a comprehensive survey conducted by the bank. The Q4 2010 survey was carried out September 25 to October 9, based on a sample of 881 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. \[ \text{Index} = \frac{\sum w \cdot D_i}{(\text{base value } XX = 100)}; \] 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: 9.1%
- Construction: 28.4%
- Financial institutions: 9.1%
- Information technology: 6.8%
- Law offices: 4.5%
- Petrochemicals: 12.5%
- Real estate: 21.6%
- Tourism: 8%

Respondent profiles
- Chairmen: 34.1%
- CEOs: 28.4%
- Vice-presidents: 22.7%
- Middle managers: 11.4%
- Junior managers: 3.4%

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

Analyst certification

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Additional disclosures

1 - This report is dated as at 18 October 2010.
2 - All market data included in this report are dated as at close 17 October 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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