Saudi business confidence climbs cautiously
Executives expect progress, bank lending a concern

♫ Q1 2010 BSF Confidence Index rises to 99.4 from 98.2 in Q4 2009.

♫ Majority of businesses expect overall business and revenue
growth in the next two quarters as macro-economic conditions improve

♫ Businesses remain pessimistic about banks’ attitude toward lending

♫ Almost 39% of companies are planning to hire new employees in the next two quarters, although nearly 48% plan to maintain a freeze on hiring

Company executives in Saudi Arabia are optimistic that the domestic business climate is poised to take a turn for the better over the next two quarters, although many remain cautious about everything from hiring new employees to replenishing their inventories, according to the findings of Banque Saudi Fransi’s debut business confidence index.

Expectations that oil prices will remain favourable and signs that a moderate recovery is taking hold in many global economies are leading most business executives in the largest Arab economy to anticipate financial indicators will swing in a positive direction over the next two quarters. The findings of the Q1 2010 BSF Business Confidence Index come in line with our view that an economic recovery in the kingdom is likely to follow a gradual and measured course this year, with more improvements likely to take place in the second half of the year than in the first.
While sentiment is upbeat, the major hurdle standing before a full recovery in the Saudi economy is the bank lending situation, which business leaders polled believe has failed to improve in a marked way. A majority of the 824 companies surveyed are frustrated by the lack of availability of bank credit; 59% of executives said the lending attitude of financial institutions falls short their expectations, down only slightly from 61.8% in Q4. For comparison reasons and to establish a base line, a survey was carried out during November and was not published.

Overall business confidence notched up to 99.4 points in Q1, compared with 98.2 points in Q4 2009. A base value of 100 represents Q3 2009. Respondents of the survey, conducted between January 15 - 23, 2010, expressed the following perspectives about the general economic climate and how they expect it will bear on the performance of key business indicators:

- An overwhelming 89.9% of respondents expect the Saudi economy would be in “better” or “much better” condition in the next two quarters, with half expressing the latter forecast. This is up from 76% of respondents expressing the same view in Q4. None of the respondents in the survey anticipate the economic outlook would worsen.

- More than two thirds of company executives conveyed confidence that their organisation’s financial performance was set to improve in the next two quarters. A sizeable 69% of businesses assume their companies’ financial performance would be stronger, up from 53.7% in Q4. Another 30.7% foresee steady performance in the next six months, while none of the executives expect their financial performance would weaken over the period.

- A full 69.3% of respondents expect company revenues will grow in the coming two quarters, while 52.3% of business executives are anticipating sales will rise. Still, a good proportion of businesses remain cautious about their corporate prospects, with 30.7% of executives estimating revenues could fall in the next six months, up from 25% in the last survey. Just over a third (34.4%) believe sales will dip over next the two quarters.

Executives surveyed in the index were drawn from a variety of sectors, including wholesale and retail, industry, construction, real estate, tourism, information technology, financial institutions and advertising.

**Oil prices seen robust**

Businesses assume the oil price environment will remain favourable for the next two quarters. The price of oil is a significant confidence indicator as to the health of the Saudi economy since Saudi Arabia, the world’s most influential oil producer, derives almost 90% of state revenues from exports of oil. Demand for and prices of oil also have significant implications for the non-oil sector, particularly petrochemical exports.

A slight majority of respondents, 52.9%, expect oil prices would rise above $85 a barrel during the forecast period. Oil prices have hovered around $75 for a few months now, bolstering the investment case for oil producers like the kingdom, which has cited this as a fair price that enables it to keep investing in capacity-boosting hydrocarbon projects while building up infrastructure to cater to its growing population.

However, not all business leaders shared the same optimism in their outlook for energy markets; a substantial 47.1% anticipate oil prices will fall below $75 a barrel, including a
third who anticipate the price of crude could trip below $70. As with most questions in the survey, however, respondents were not overly bearish. None of the respondents saw oil prices falling below $65 a barrel – a level we regard as high enough to allow Gulf energy exporters, including Saudi Arabia, to balance their fiscal budgets.

Demand growing, but caution prevails

While businesses assume a pick up in consumer demand is likely to take hold in 2010, they are waiting for hard evidence before they start to rethink their business plans, the survey showed. Some 44.5% of business executives (against 33.7% in Q4) are not planning to change prices for their products or services in the next two quarters, preferring to keep prices steady as they test demand appetite. Still, just over a third of Saudi businesses said they expected to raise prices in the next two quarters (against 35.9% in Q4), while 9% plan to lower prices (up from 8.2% in Q4).

Many companies are also still wary about building up inventories too substantially following the slowdown in 2009. Imports to Saudi Arabia fell by more than a fifth last year as companies adjusted to a slowdown in demand that accompanied the global financial crisis. The survey showed businesses haven’t shifted their perspective much since in Q4.

Asked about what they planned to do with inventories in the coming two quarters, 37.5% of businesses said they would replenish them such that they remain at current levels. Just over a third of respondents (33.7%) plan to boost inventories over the same period, while another 29% expect inventories to fall.

Most companies would either keep production capacity the same or raise it in the coming two quarters, according to the survey. Some 38% said they would raise capacity and 41.6% said they would keep it steady. A fifth of respondents expect to reduce production capacity.
The credit question

A pick up in the pace of bank credit is a precondition to an economic revival, particularly for the private sector. The other precondition is the private sector’s expansion appetite. The overwhelming sentiment of businesses is that banks have not been able to deliver so far. A major 58.6% of business leaders said the lending attitude of financial institutions fell below their expectations. This marks a slight improvement from 61.8% in Q4, although it underpins the continued mismatch between the general economic outlook and the level of bank risk aversion.

In view of their cautiously optimistic stance, companies remain vigilant about their hiring plans, the survey showed. While none of the executives surveyed planned to lay off any of their staff in the next two quarters, 47.8% of respondents said they would maintain a freeze on hiring, down from 53.3% in the Q4 survey. Job seekers can also take comfort in the growing number of companies that are planning to recruit employees in the next two quarters; some 38.7% expect to boost hiring over the period, up from 29.8% in the last survey.
The Saudi Arabian Monetary Agency (SAMA) has taken steps to strive to stimulate bank credit, particularly by slashing interest rates on deposits and lowering bank reserve requirements. SAMA took the necessary steps within its regulatory mandate, but the moves had little bearing on boosting credit expansion; bank claims on the public and private sectors fell almost 5% last year (latest data).

Most respondents – 58.9% – do not foresee any change in interest rates in the next two quarters as the central bank seeks to sustain an environment where banks are encouraged to lend once risk appetite improves. SAMA stated earlier in January that there was no plan to raise interest rates since inflationary pressures were not concerning and demand for loans was not strong enough. Last year, SAMA reduced the benchmark repurchase rate to 2% and the reverse repurchase rate to 0.25%.

In Q4, businesses had greater expectations for interest rates to change, with only 26.5% of respondents at the time thinking rates would remain steady.

We anticipate banks will loosen up on their attitude toward lending, particularly in the second half of the year, both because of a measured increase in private sector demand for credit to finance expansion projects as well as the need to improve profits which sagged during 2009, in a low interest rate environment. Through to November, cumulative Saudi bank profits were down 9.6% from the year earlier. According to our forecasts, loans to the private sector should grow 8% in 2010, up from 2.1% in 2009.

Real estate in favour

Looking ahead for possible investment opportunities, real estate remained the most-attractive investment prospect for business leaders, although by a smaller margin than in the last survey. Real estate has an element of low-risk perception among Saudi businessmen. Asked which single asset class would provide the best returns, 47.2% of business executives ranked real estate above equities, bonds or holding cash – down from 59.4% in Q4 survey.

Real estate lost some favour to hard currency and equities – the second and third most-appealing investment prospects for business leaders. Some 26.6% of respondents (against 21.5% in Q4) ranked cash the best medium-term investment opportunity, while 21% said equities (against 12.7% in Q4) and 5% answered bonds.

The sentiment among companies is that real estate prices in the kingdom have likely bottomed out; 65.5% of respondents said they expected real estate prices in the kingdom would either rise or stay the same in the next two quarters. A substantial 43.4% of surveyed business executives saw property prices going up, compared with 23.9% who expect prices would fall over the period. The
sentiment toward real estate prices has warmed up since Q4 – when a greater proportion of respondents, 26.7%, saw prices falling.

Strong interest in real estate investments comes as executives express uncertainty about the future direction of the stock market, which rose almost 14% between September and the end of January, largely underpinned by a petrochemicals rally. The most-common response to a question about how equity markets would perform in the next two quarters was “not sure”. Some 42.4% of executives gave that answer, while 22.7% think shares will rise and 19.7% assume they would decline. Among equity sectors, 47.7% of businesspeople listed petrochemicals as their most-preferred sector, followed by 34% who said banking was their best pick.

**Inflation, currency policy on the wayside**

The question of rising prices has resurfaced on the minds of business executives, the index showed, although only a minority – 43.4% – expect inflation would rise in the coming two quarters, on par with levels recorded in Q4. Some 23.9% of respondents expected inflation levels would decline, while another 22.1% saw inflation staying the same.

A dramatic 83% of respondents, meanwhile, expected no change in the value of the riyal currency over the period under projection, according to the survey. The riyal is pegged to the U.S. dollar at a fixed rate of 3.75, and policymakers have reiterated on many occasions that the peg is a source of stability for investors that they will continue to maintain. We hold the view that there will be no change in currency policy for the foreseeable future.
Analysis

The perspectives offered by business executives in the Q1 2010 BSF Business Confidence Index signal that while optimism is surely on an upward curve, managers think it could take some time before the better economic climate filters down to their bottom line. Companies are, in general, certain that the worst of last year’s slowdown has passed; what they are divided on is when business activity and demand will pick up substantially.

It is certainly difficult for businesses to forecast when a downward business cycle will end to pave the way for the start of a new one – this is not unique to Saudi Arabia. The global picture, particularly in Europe and the United States, shows us that the path to full recovery is going to be a long and bumpy one, fraught with unemployment.

Despite the 5.7% (annualized) Q4 GDP figure in the U.S. economy, record low interest rates and equities still holding their relative gains, confidence is dismal. There is little in the recent U.S. GDP data that to change our view that the American economy, as the boosts from inventories and the fiscal stimulus fade, faces downside risks. Markets are tempted to believe that things have returned to normal, but we expect the global environment will be a challenging one to operate in during 2010, which could make investors more conservative.

Average 2010 oil prices should be higher than 2009 but we may not witness a sustainable rally, above $78 per barrel (WTI), as some forecast. We are beginning to observe some downside risks to oil prices. While the year kicked off with oil above $80 per barrel, demand and physical stocks are placing downward pressure on prices. In 2009, oil started the year around $40 per barrel and gradually averaged up. This year we could be seeing the reverse: oil starting at a higher level and averaging down. Economic recessions are having an asymmetrical impact on oil demand, affecting gasoil demand more than gasoline demand. Refiners striving to meet gasoline demand have produced gasoil in excess, which has been put into stocks. We ended last summer with a massive overhang of gasoil stocks.

In our view, Saudi Arabia has weathered the global financial crisis better than many other G20 member countries. At 3.3% of GDP, Saudi Arabia’s budget deficit was more than two times smaller than the expected deficit as a percentage of GDP for all other G20 economies in 2009. Spain, Ireland and Greece face budget deficit ratios this year of around 12%, creating obvious downside macroeconomic risks. As G20 economies’ debt-to-GDP ratio is set to increase above 105%, Saudi Arabia’s government to GDP should fall to around 13% this year. The U.S. Congressional Budget Office estimates a 2050 U.S. debt ratio of 300% and Europe of 250-300% as a worst case scenario. Hence, we continue to take a very sanguine view on Saudi Arabia’s public finances even as the global economic recovery picture looks hazy.

In the recent past, equity investments have fallen out of favour with Saudi investors, who have opted instead to park money in real estate and keep it in their bank accounts. Some regulatory developments could have a positive affect on sentiment in the coming months. The upcoming mortgage law – which is likely to be enacted within the first half of the year – will take time to provide a renewed momentum to the property sector.

Saudi Arabia’s real estate sector suffers from a shortage in supply, which has kept rental inflation at exceptionally high levels in the past two years. The property sector has been somewhat immune from the sharp drops suffered in neighbouring countries such as the United Arab Emirates and Qatar, primarily due to the comparatively large population of Saudi nationals and a sustained supply-demand gap. Inflation is not a key worry in most of the Gulf where some countries, including the UAE and Qatar, are still on a deflationary path. Inflation is likely to average 4.3% in 2010, with domestic economic activity and demand keeping price pressures intact. The dollar, which is on an appreciation path, and low inflationary environment in the Euro zone are contributing to lower imported inflationary pressures in the kingdom.

We expect 3.9% growth in real GDP this year, compared with 0.2% last year, as government and private sectors accelerate.
But encouraging banks to boost their credit portfolios remains one of the biggest hurdles standing before a full recovery in the Saudi economy. While they have been awash with liquidity for some time now, lenders in the kingdom are cautious about taking risks with their money. Private sector appetite for project expansion, meanwhile, is subdued compared with previous years, especially prior to 2008.

These circumstances cut into banks’ profitability during 2009 and prompted the widespread adoption of risk-aversion policies. The contraction in bank lending to the private and public sectors last year was a key factor behind the slowdown in economic growth. The government has largely picked up the slack with a stimulatory state spending programme that draws on its stores of foreign assets. The state announced its largest-ever budget for 2010, which could go some way toward improving business sentiment in the coming months. Government spending will remain high.

Banks’ reluctance to extend credit is not a question of liquidity; their deposits of cash at the central bank have doubled and their foreign assets rose by about a third last year. The credit aversion of Saudi banks is not unique in the Gulf region or globally. The European Central Bank’s January bank lending survey, along with December money supply data, suggest credit conditions remain very tight despite the ECB’s unlimited provision of liquidity to lenders. In our view, the key to unlocking even greater optimism among Saudi business leaders will be a move by banks to increase financing to the private sector. This will happen once banks are comfortable that their provisioning needs have been met – a shift in sentiment we expect will take place this year.

A turn in bank profitability will also add impetus to the performance of equities. However, we are uncertain as to the degree to which the Saudi stock market is positively correlated to global equities. We find little room to expect that the Saudi market will decouple in an event of a correction in global equities. Volumes in the local equity market have been low, with investors either deciding to take a cautionary approach or directing liquidity to support their businesses’ cash flow position during the risk-averse credit environment.

The private sector’s willingness to expand and grow is the other half of the growth puzzle. The government has done what is necessary and banks will also gradually begin to lend. But the global environment has demonstrated the inability for any economy to be insulated from the aftershocks of the recession. Confidence, or lack thereof, that prevails in 2010 globally will have implications on the way local business attitudes develop. We expect sentiment will be a mixed bag for much of the year.
About the survey

The BSF Index attempts to gauge market sentiment on a quarterly basis, using a comprehensive survey conducted by the bank. The Q1 2010 survey was held between Jan. 15-23, based on a sample of 824 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. Index = Σ w.Di / (base value Q3 2009 =100); where w is weight, Di 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 Q3 2009. Higher scores indicate a positive result, while scores below 100 demonstrate that business confidence is on a falling trend.

Industries surveyed

Wholesale and retail: 30.8%
Industry: 23.9%
Construction: 17.1%
Real estate: 11.9%
Tourism: 5.8%
Information technology: 3.8%
Financial institutions: 3.5%
Advertising: 3.2%

Respondent profiles

Chairmen: 32.8%
CEOs: 38.8%
Vice-presidents: 13.3%
Middle managers: 7.9%
Junior managers: 7.2%

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 31 January 2010.

2 - All market data included in this report are dated as at close 30 January 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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