



Saudi Arabia Continues Along Its Reform Path

Saudi Aramco's IPO represents the next step.

December 2019

KEY INSIGHTS

- The Saudi Aramco recent initial public offering (IPO) illustrates Saudi Arabia's determination to reduce its long-term reliance on oil.
- This should help broaden the opportunity set available to emerging markets investors.
- Reforms could be quicker and more extensive, but we are encouraged by the direction of travel.

Within the emerging markets universe, Saudi Arabia brings a range of opportunities and distinct challenges. Abundant natural resources, a young population, a future king with reformist intentions, and a large and growing regional economy are attractive attributes for investors. These features need to be balanced, however, against a range of risks, including the potential for social unrest, the vagaries of the oil market, and geopolitical uncertainty.

The listing of the kingdom's state-owned energy giant Aramco brings into focus the efforts of the country to use its energy assets to diversify its economy beyond a historical dependence on oil revenues.

The Importance of Saudi Aramco to the Saudi Economy

Saudi Aramco, a state-owned energy company, is the jewel in the crown for the

Kingdom of Saudi Arabia's vast energy assets. Its IPO listing¹ has attracted much attention due to its size, matched only by the IPO of Chinese e-commerce giant Alibaba in 2014, which raised an astonishing USD 25 billion. The listing is part of the country's broader Vision 2030 reform program. The program is Saudi Crown Prince Mohammed bin Salman's aggressive drive to modernize the conservative kingdom and to diversify the region's biggest economy away from its dependence on oil.

Saudi Arabia makes over 60% of its revenues from the oil sector, and Aramco is its most crucial contributor. The listing is designed to help fund plans to boost non-oil industries and develop public services sectors such as health, education, infrastructure, recreation, and tourism.



Seun Oyegunle
Investment Analyst

“The reform efforts are a step in the right direction, but we would like to see further acceleration.”

¹ December 11, 2019.

Saudi Aramco—Key Facts



- The company provides one of every 10 barrels of crude oil produced globally per day.¹
- It is one of the lowest-cost producers of oil with lifting costs below USD 3 per barrel.²
- With the current oil price trading around USD 60 per barrel, it is ranked as the most profitable company in the world.²



- We believe that the company is well run and best in class compared with global peers in terms of asset quality, CO² emissions, and capital expenditure per barrel of oil produced.



- On social and governance, as a private company, Aramco has been a good corporate citizen, but it cannot extricate itself from its major shareholder, the government of Saudi Arabia, which has a controversial record on human rights and governance.



- The listing represents just 1.5% of the total shareholding. This initial listing has been largely taken up by Saudi domestic investors and sovereign wealth funds. There will also be institutional investors, primarily because of the inclusion in the MSCI Emerging Markets Index.

¹ Sources: OPEC and Saudi Aramco, as at November 30, 2019.

² Sources: OPEC and Moody's, as at November 30, 2019.

Steps to Attracting International Investment

The government has already been spending aggressively on infrastructure programs, including the construction of several new “economic cities” across the country. There have also been major financial commitments to develop the country’s electricity grid, waterworks, and telecommunications network.

The listing is also another step toward increasing international investment. Only since 2015 has the stock market been open to international investors. With the kingdom’s Tadawul stock exchange being by far the largest in the Arab world, this should encourage greater investment from abroad over time. The recent inclusion in the MSCI Emerging Markets Index should also help drive flows.

Broadening Opportunities, Beyond Energy

The Saudi government has already had some success in diversifying its economy. We have been focusing on three main areas: health care, consumer, and banking.

The health care sector offers strong structural growth potential due to the mismatch between supply and demand. There are only four hospital groups serving the capital Riyadh, with a population of almost 8 million people, and there is an acute shortage of beds.

The consumer sector is also attractive and plays into a key emerging market theme: the expanding middle class and rising incomes. Valuations of companies in consumer staples and consumer discretionary compare favorably with those in several other large emerging markets such as India, Indonesia, and Mexico.

Meanwhile, the banking sector is an area that we have been focused on for some time. With high barriers to entry, U.S. dollar-pegged dividends, and a well-capitalized banking system, the sector has many attractive attributes. We are particularly encouraged by the potential for increased mortgage growth. Mortgage penetration is only around 10% of gross domestic product in Saudi Arabia, which is very low relative to both emerging and developed market peers. Mortgage loan growth also supports corporate margins as it is higher yielding, while a fixed rate book of business also helps to limit downside potential from lower interest rates. We recently met with a Saudi bank that had recorded a 52% year-on-year growth in mortgages in the third quarter and was guiding for strong growth into 2020.

Keys to Success

There are areas where reforms could be quicker and more extensive, however. Employment and wages are important. The Arab Spring of 2011 focused the Saudi government minds on

providing fuller employment and higher wages, especially for young workers. More needs to be done to reduce unemployment and create jobs. We would also like to see a greater focus on training, especially for women and the younger population.

Meanwhile, the kingdom also needs to attract more foreign direct investment (FDI), and there remains a need for foreign skilled workers. While non-oil revenue is increasing, income from crude exports remains the linchpin of Saudi Arabia's economy. The reform efforts are a step in the right direction, but we would like to see further acceleration.

Today, the country represents 2.5% of the MSCI Emerging Markets Index.² If we continue to see improvements, we envisage the Saudi component of the MSCI Emerging Markets Index rising, especially as there is a pipeline of around USD 150 billion of potential IPOs coming to market. Alongside Saudi Aramco's IPO, these are opportunities we will continue to monitor.

² Financial data and analytics provider FactSet. Copyright 2019 FactSet. All Rights Reserved. As of November 30, 2019.

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