GCC Budgets: Adapting to the New Oil Reality

March 2016

Executive Summary

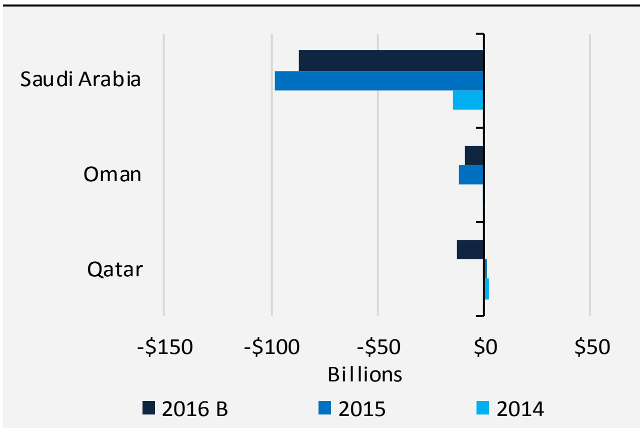
> *"While the substantial fiscal buffers that have been built-up in most countries over the past decade will allow governments to maintain spending plans in the near-term, in almost all GCC countries it increases the urgency for fiscal consolidation in the medium-term."*
>
> ***Ms. Christine Lagarde, Managing Director of the IMF***

GCC nations have traditionally been highly reliant on oil, the largest revenue contributor in most of these economies. This dependency has been a source of major risk, especially in the current environment, where the persisting glut in oil supply has pushed prices to near 12-year lows. Although the large fiscal buffers have cushioned the Gulf nations from short term price shocks, the vulnerability of these economies to a sustained slump in oil prices has compelled them to adopt a series of reforms. The recent budgets in Saudi Arabia, Qatar, Oman and the UAE, for the first time in decades, saw cutbacks in expenditure, subsidy reforms and plans to diversify revenue base, indicating that the Gulf countries are gearing up to cope with the recent downturn in oil markets. Kuwait and Bahrain are also set to release their budgets in mid-2016 and are anticipated to undertake similar measures. What sets the 2016 budgets apart from those announced in previous years is not the numbers or the allocations but the emergence of a political will to improve efficiencies, curb wasteful expenditures and instill fiscal discipline. In this report, we look at these budgets, the reform measures announced and the broader long-term implications of these changes on the respective economies.

GCC Governments Tighten Belts to Deal with the Oil Slump

GCC countries which were accustomed to large fiscal surpluses are now adapting to the new normal in oil prices. Saudi Arabia, the biggest and most influential member of the GCC region has projected an $87 billion deficit this year. Similarly, Qatar announced its first budget deficit in 15 years and Oman witnessed a deficit in 2015 as well. The GCC countries have started to tighten their belts to cope with the recent downturn in oil prices. These nations have shown a clear intent of moving away from expansionary budgets that were a key feature of their economies during the past decade.

Budget Balances in GCC Economies



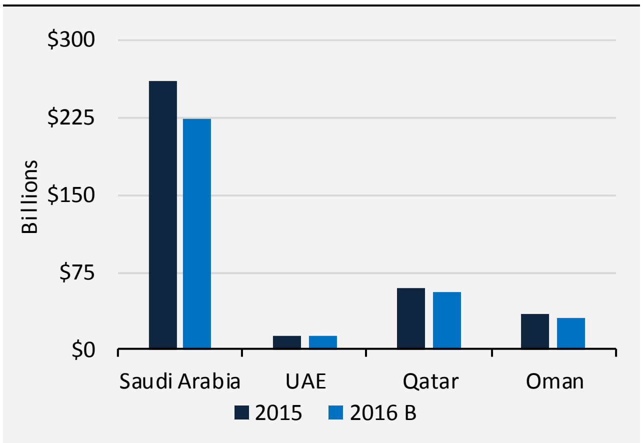
Source: Alkhabeer Capital

Note: For Qatar, the 2015 figure represents surplus for the nine months ended December 2015. The 2014 figure represents the surplus for the 12 months ended March 2015.

Cutbacks in Overall Expenditure Levels

Gulf States have for years incurred high levels of spending towards the infrastructure and social sectors. However, with oil prices dropping sharply, recent budgets announced by the GCC countries have shown a decline in overall expenditure levels. Saudi Arabia lowered its budgeted spending for 2016 by about 14%, compared to the actual expenditure in the previous year. Likewise, Qatar and Oman announced lower outlays for this year.

GCC Nations have Lowered their Spending Levels



Source: Saudi Ministry of Finance, Alkhabeer Capital

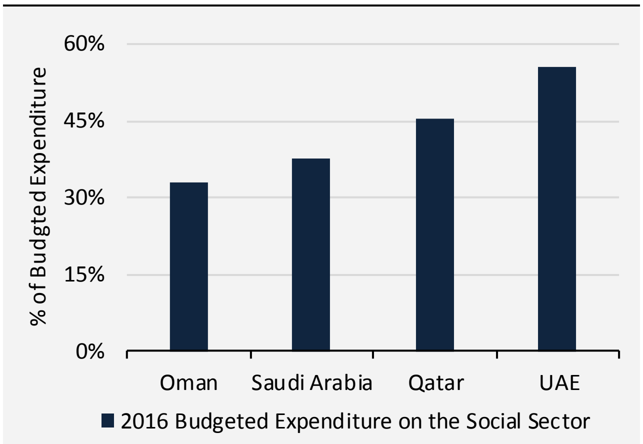
Note: 2015 figures for Saudi Arabia and Oman represent actual expenditures, while 2015 figures for Qatar and UAE represent expenditures forecasted in the previous budget.

The reduced expenditure levels reflect a cautious stance on spending as the region adopts unprecedented measures to counter the oil price plunge. One should also bear in mind that when the budgets were announced, oil prices were close to $40 per barrel, while the market price by end of January 2016 plunged to near $30 per barrel. If the current era of low prices prolongs or worsens further, the GCC region could witness further cuts in government expenditures.

Spending on Key Social Sectors Continues to Retain a Large Share

Despite cutbacks in overall expenditure, most Gulf economies have continued their focus on key sectors such as education and healthcare, indicating the government's efforts to prioritize spending on essential areas. Although Saudi Arabia has allocated a lion's share of the overall spending to defense and security, the Kingdom has allocated about 35% to the education and healthcare segments. The UAE also approved a slightly smaller federal budget for 2016, but allocated more than half of the projected expenditure to sectors such as education, health, social development, and public services. Even the smaller Gulf States of Qatar and Oman announced conservative budgets for 2016 which focused on lower expenditure levels but prioritized social spending.

Expenditures on the Social Sector



Source: Saudi Ministry of Finance, other sources

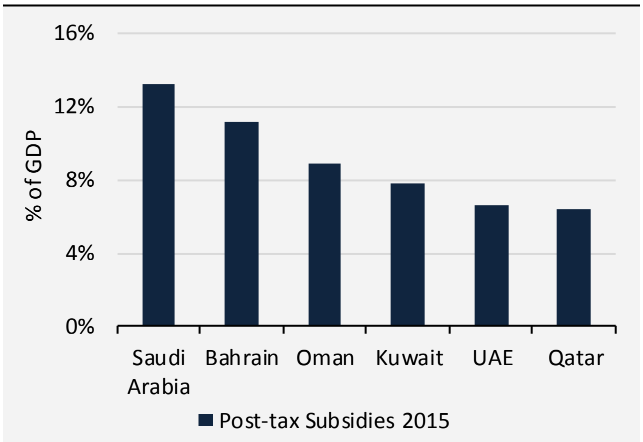
Note: Social spending includes expenditure on education, health, social development and public services. Figures for Qatar include spending on infrastructure .

As a result, sectors such as education and healthcare are likely to remain buoyed, despite oil prices that are expected to remain pressured in the short term impacting hydrocarbon revenues in the Gulf countries. The GCC countries have also indicated that the shortfall in budgets would rather be funded by borrowings than resorting to more austerity measures. In our opinion, this move is expected to have a twofold impact; firstly, economic growth will not be impacted to a great extent and secondly the social sector spending will keep public resentment at bay.

Gulf Countries Adopt Subsidy Reforms

Besides overall spending levels being reduced, the GCC nations have made cutbacks in subsidies as well. Traditionally, countries in the Middle East region have for a number of years relied heavily on energy subsidies to maintain social stability. Subsidies have also resulted in wasteful consumption and harmful effects on the environment. Despite calls by various observers, urging governments in the region to reduce energy subsidies, Gulf nations had been reluctant to alter their subsidy policies as removing subsidies could be a contentious issue. Kuwait had briefly lowered subsidies on kerosene and diesel in early 2015 but reversed its decision following protests in Parliament. According to the International Monetary Fund (IMF), GCC economies were estimated to have spent about $175 billion last year on post-tax subsidies, accounting for about 10% of the region's overall GDP.

Subsidies Account for a Significant Share of GDP



Source: IMF

In July 2015, the UAE announced a landmark decision to deregulate fuel prices and reduce its subsidy burden, thereby sending a message that the nation was willing to undertake reforms to deal with the changing macro environment. Subsequently, other Gulf economies have also followed suit and announced measures to slash subsidies and reduce pressure on state budgets. Saudi Arabia increased fuel prices by nearly half as part of a reform program to make its economy more efficient and productive. The Saudi government has affirmed that it would review its current support program for the local populace and gradually cut subsidies on utilities. Similarly, Oman initiated steps to lower subsidies on utility bills, fuel and other goods by almost two-thirds in 2016 and raised gasoline prices by around 33%. Bahrain raised petrol prices for the first time in 33 years and Qatar announced a 30% increase in local gasoline prices.

We believe that the cut in energy subsidies seems appropriate in the current environment of weak oil prices. These long overdue measures adopted by the Gulf region reflects the growing pains that lower crude oil prices have had on their governments' finances. Rationalizing subsides is expected to not only bring in fiscal savings but also improve efficiency in usage of resources and help the governments to channelize funds towards broader fiscal diversification.

Generous state subsidies and benefits had reduced the "motivation of individuals to take initiatives and be progressive."

Qatari Emir Sheikh Tamim bin Hamad al-Thani

Governments Mull Widening the Revenue Base

There are several other measures governments in the region are taking to increase revenues. These include divestments and a rise in taxes.

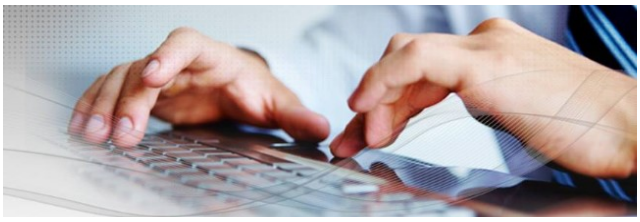
Divestment Plans on the Agenda

One of the key indications by some of the Gulf economies to boost non-oil revenues has been the privatization of state-owned companies. In its budget, Saudi Arabia disclosed plans of reducing stake in a few public companies within the next five years. Soon thereafter, reports emerged that the Kingdom was mulling an initial public offer (IPO) for Saudi Arabian Oil Co (Aramco), which could potentially become the world's largest listed firm. Apart from the Kingdom, Oman also signaled plans of privatizing firms in a bid to raise money and encourage private sector growth and development. Three state-owned Omani companies are already confirmed to float IPO's on the Sultanate's local bourse this year and it is anticipated that firms in the mining, education, transportation and healthcare services could be privatized by the government over the coming years. Qatar has indicated plans of privatizing a few state-run firms as well. We expect other economies in the region to follow suit as privatization will not only help in increasing revenues but will also support development of the private sector.

Proposals to Levy Taxes and Fees

Prospects of higher taxes in the Gulf region have been steadily gaining steam as the GCC nations initiate measures to compensate for lower oil revenues. A major reform planned across the GCC countries has been the introduction of a Value-Added Tax (VAT). A tentative plan for its implementation has been agreed upon by the Gulf nations. This could lead to the imposition of a unified VAT of up to 5% from 2018. The latest agreement calls for all the six members to have their own VAT laws and subsequent work on a unified VAT system would begin when any two nations are ready with their tax laws. A pan-GCC VAT has been discussed for many years and would likely be a major economic reform in the region which has traditionally been tax-free and attracted a large number of overseas workers. It is expected to boost revenues and reduce the burden of the respective governments. According to the IMF, levying a 5% VAT has the potential to enhance the region's non-oil GDP by 3.5%.

Meanwhile, Kuwait recently hinted at the introduction of income, corporate and sales taxes to shore up its finances. Likewise, Oman approved a law which levies a 15% income tax on all corporates without exception, thereby increasing the corporate tax rate from an earlier 12% imposed on firms earning more than OMR 30,000 ($78,000). The Sultanate nation also amended its fee structure on a range of services such as the services offered by the administration in a bid to augment its non-oil income.



Reforms Aimed at Increasing Efficiencies and Plug Leakages

The striking feature of the recent GCC budgets was not the budget numbers and allocations; rather the strong government intent to work towards curbing wasteful spending, and instilling fiscal discipline and transparency. Saudi Arabia's recent budget release indicated that the Kingdom would establish a public finance unit to monitor and ensure the avoidance of budgetary overruns this year. The country also affirmed that the National Project Management Agency would help optimize capital expenditures, while current account spending would be rationalized by reducing the growth of recurring expenses like wages of public sector employees. Moreover, the Kingdom expressed its intent to utilize technology to strengthen the government mechanisms, in order to raise accountability and improve the efficiency of tax collection.

On similar lines, Oman indicated that it would set up a joint technical committee of the Ministry of Finance and the Secretariat-General of the Supreme Council for Planning to ensure efficient spending going forward. The budget also proposed trimming government department expenditures such as limiting travel and administrative expenses. The Sultanate would also form a Macro Fiscal Unit to identify the gap between spending and resources and advise on the options to bridge the difference. Similarly, Qatar and Kuwait also indicated their commitment towards keeping their 2016 spending in line with the planned levels. Considering that the Gulf governments have conveyed their commitment to keep a tight hand on their 2016 expenditures, we believe that there are very limited prospects of significant budgetary overruns this year, in contrast to the trend seen in the past.

"The current situation provides an opportunity to achieve further efficiency, especially in the operating costs of various government departments, which represent a large stake of the total public expenditure."

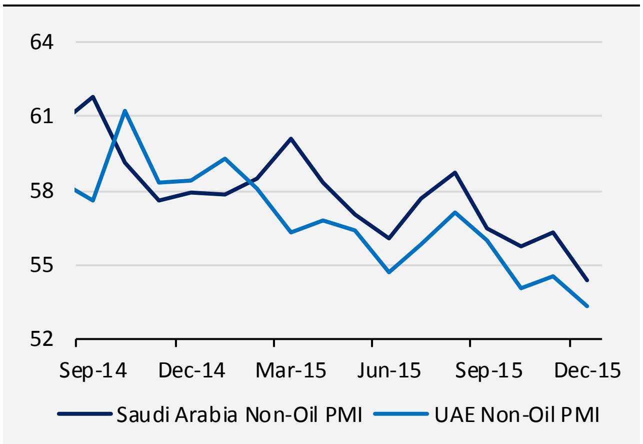
HE Ali Shareef Al Emadi, Qatar Minister of Finance

Impact of the Budgets & Outlook for the GCC Economies

The Multiplier Effect of Budget Cuts Would Weigh on the GCC Economy

Budgets in the GCC countries have been of vital importance as government spending has been a key driver of region's economic and social progress. Currently, growth in the non-oil sector continues to outpace the rate of expansion seen in the region's hydrocarbon sector, as these nations reap benefits of diversification efforts undertaken in the past. However, we believe that the non-hydrocarbon sector cannot continue to remain largely resilient to low oil prices for a prolonged period, especially if we consider the high reliance of the Gulf economies on government expenditure. The non-oil sector has started showing signs of weakness, particularly reflected by the most recent PMI readings in Saudi Arabia and the UAE which are close to multi-year lows.

Pace of Expansion in the Non-oil Sector is Easing



Source: Bloomberg

Tremors of spending cuts and rollback in subsidies are likely to be felt on the GCC nations' corporate performance going forward. Many Saudi companies have estimated the impact of price hikes in fuel, electricity and natural gas feedstock on their earnings. The table below highlights the impact for some select companies in each sector.

Impact of the Recently Introduced Saudi Arabian Reforms on its Non-Oil Economy

Company	Direct Annual Cost Impact
Petrochemical	
Advanced Petrochemical Co	~ SAR 6 Million
Methanol Chemicals Co	SAR 30 Million
National Industrialization Co	SAR 190 Million
Rabigh Refining and Petrochemical Co	SAR 300 Million
Saudi Arabia Fertilizers Co	~ SAR 6 Million
Saudi Arabian Mining Co	SAR 120 Million
Saudi Basic Industries Corp	~SAR 689 Million
Saudi Kayan Petrochemical Co	~ SAR 33 Million
Yanbu National Petrochemical Co	~ SAR 14 Million
Alujain Corporation	SAR 10-40 Million
National Petrochemical Co	SAR 50 Million
Sahara Petrochemical Co	~ SAR 5 Million
Saudi Industrial Investment Group	SAR 140-180 Million
Real Estate, Building & Construction	
Abdullah A.M. Al-Khodari and Sons	SAR 22.1 Million
Electrical Industries Co	SAR 3 Million
Bawan Co	SAR 12.5 Million
Makkah Construction & Development Co	SAR 15 Million
National Gypsum Co	SAR 3.5-4 Million
Saudi Cable Co	~ SAR 7 Million
Saudi Ceramics Co	~ SAR 11 Million
Saudi Industrial Development Co	SAR 4.4 Million
Agriculture & Food	
Al Jouf Agricultural Development Co	SAR 26 Million
Almarai Co	SAR 200 Million
Herfy Food Services Co	SAR 10 Million
National Agricultural Development Co	SAR 70 Million
Cement	
Saudi Cement Co	SAR 68 Million
Yamama Cement Co	SAR 60 Million
Al Jouf Cement Co	SAR 35 Million
Arabian Cement Co	SAR 40 Million
City Cement Co	SAR 15-20 Million
Eastern Province Cement Co	SAR 43 Million
Hail Cement Co	SAR 24 Million
Najran Cement Co	SAR 29 Million
Northern Region Cement Co	SAR 34 Million
Qassim Cement Co	SAR 47 Million
Southern Province Cement Co	SAR 50 Million
Tabouk Cement Co	SAR 21 Million
Yanbu Cement Co	SAR 45 Million

Company	Direct Annual Cost Impact
Retail/Consumer Staples	
United Electronics Co	SAR 4.4 Million
Al Othaim Holding Co	SAR 16 Million
Aldrees Petroleum & Transport Services Co	SAR 27 Million
Saudi Company for Tools and Hardware	SAR 4-6 Million
Energy & Utilities	
National Gas & Industrialization Co	SAR 12.5 Million
Industrial Investment/Multi-Investment	
Al Sorayai Trading & Industrial Group	SAR 11-13 Million
Filing and Packing Materials Manufacturing Co	SAR 2.5-3 Million
Middle East Paper Co	SAR 14 Million
National Company for Glass Industries	SAR 3.5 Million
National Metal Manufacturing & Casting Co	SAR 4 Million
Saudi Industrial Services Co	SAR 15 Million
Saudi Pharma. Indus. & Medical Appliances Corp	SAR 6 Million
Takween Advanced Industries Co	SAR 15 Million
Hotel & Tourism	
Dur Hospitality Co	SAR 5 Million
Media & Publishing	
Saudi Printing & Packaging Co	SAR 2.5-3 Million
Transport	
Saudi Public Transport Co	~ SAR 7 Million

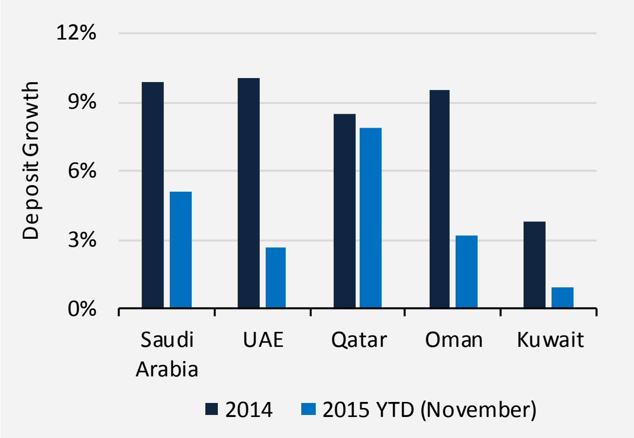
Source: Zawya, Reuters, Bloomberg

Cuts in government spending and a rise in taxes could have a multiplier impact on the economy, directly or indirectly impacting consumption. For instance, private consumption which accounted for 41% of the Saudi GDP in the third quarter of 2015 is likely to witness a slowdown as disposable incomes take a hit from the recently introduced subsidy reforms. Other than that, higher consumer price inflation across the GCC countries could be witnessed given that the recent measures taken by the Gulf governments to introduce reforms could increase domestic prices moving ahead. The IMF has forecasted growth in the GCC economies to slow to 2.7% in 2016 from a projected growth of 3.2% for 2015. The IMF further expects Saudi Arabia's economy in 2016 to grow by 1.2%, the slowest pace since 2002 and the UAE economy to grow at 2.6%, marking the slowest growth rate in more than five years.

GCC Nations Plan to Raise More Debt to Fund the Budget Shortfall; Regional Banking Segment Likely to Witness a Liquidity Crunch

Over the years, the GCC countries managed to build up large foreign reserves in the era of high crude oil prices. However, the recent tough oil price environment is threatening the fiscal buffer in these countries. Amid liquidity concerns, GCC countries have already embarked on implementing measures to reduce pressure on fiscal buffers. Saudi Arabia raised debt worth SAR 98 billion from the local financial market, taking its total debt levels to SAR 142 billion by the end of 2015. Debt in the Kingdom is still low, at about 5.8% of the expected GDP. The Kingdom also announced the formation of a unit in the Ministry of Finance that would specifically focus on public debt management, to better manage debt issuances. Saudi Arabia and Qatar have also indicated plans to go global to raise more debt. We believe that other Gulf countries would adopt a similar course of raising more debt going forward to tackle liquidity concerns temporarily, taking advantage of their low debt -to-GDP ratios. The government's debt issuance program will affect the amount of liquidity available for private-sector lending. In response to the tightening liquidity, the benchmark interest rates across the Gulf nations have spiked to multi-year highs and has started raising concerns about the GCC banking sector. Additionally, the region's credit growth is highly vulnerable to government spending and oil prices. The slump in oil prices has already resulted in a slowdown in credit growth. We expect credit growth to slow down further after years of double digit growth. Furthermore, we expect deposit growth to take a hit, as the recently introduced subsidy reforms could negatively affect the real incomes of locals and weigh on the savings potential of domestic consumers.

Deposit Growth Among GCC Banks has Fallen Significantly

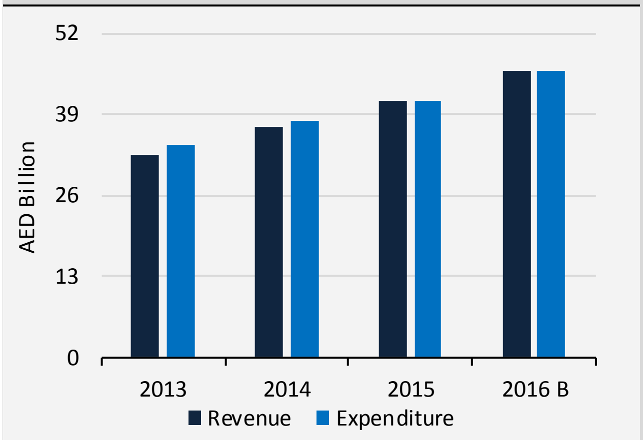


Source: Central Bank Publications

Dubai Looks Relatively Comfortable Compared to its GCC Peers

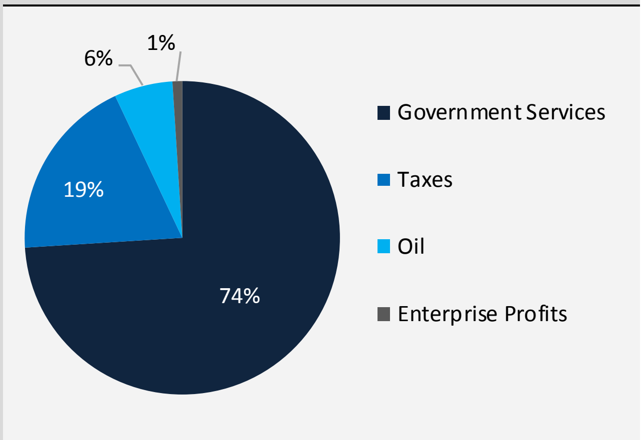
In contrast to the 2016 budgets released in the GCC region, Dubai projected 12% higher state spending at AED 46.1 billion for the year. Dubai's budget was the only one that forecasted a higher expenditure for 2016, amid expectations that an increase in revenues would result in a balanced budget for the year. A major reason is that Dubai's economy is well diversified compared to its regional peers and has low dependence on oil income (6% of the total revenues) to meet its fiscal needs. The Emirate has allotted a sizeable chunk of its 2016 budget to infrastructure, transport and other economic sectors. To support the UAE's Emiratization program, Dubai has also allocated 36% of its 2016 budget for wages and salaries of public sector employees and adding 3,000 new government jobs. With these budgetary estimates reinstating confidence about Dubai's economy, we expect the Emirate to better withstand the impact of low oil prices. However, one needs to be cognizant of the risks while considering Dubai's economic model as a benchmark, especially bearing in mind that the Emirate was close to a default in the last financial crisis.

Dubai Budget's Historical Performance



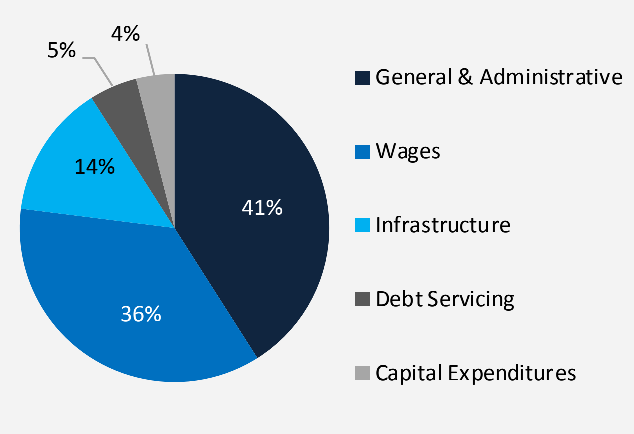
Source: Media Reports

Revenue Forecast for 2016



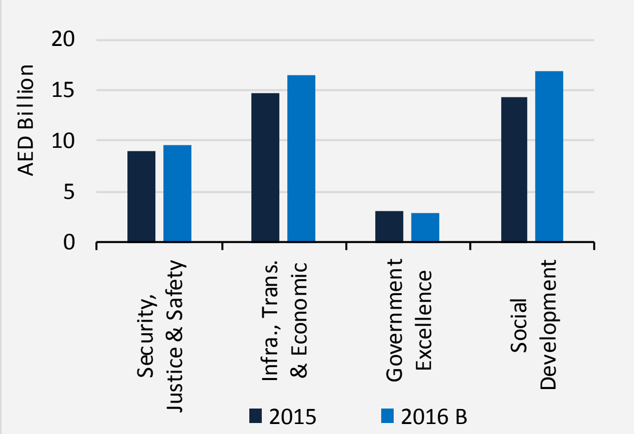
Source: Media Reports

Expenditure Forecast for 2016



Source: Media Reports

Spending Allocation to Key Segments in Dubai



Source: Media Reports

Conclusion

The recent budgets in the GCC region have been in stark contrast to those in the previous years, with governments moving away from an era of expansionary budgets to a tightening mode. As government spending has been a key driver of region's economic and social progress, we expect economic growth to be subdued in the region. The non-oil segment has already started showing signs of a slowdown, with PMI readings in the UAE and Saudi Arabia falling to multi-year lows, and 4Q15 corporate earnings across the GCC countries being broadly muted. While these economies can easily manage the drop in oil price if short lived, further reduction in expenditures could be seen if oil prices continue to remain below $30 per barrel levels for a prolonged period. Going forward, we do not expect any significant budgetary overruns in the GCC region this year, especially amid extraordinary steps taken by the regional governments to ensure efficiency in spending. We had pointed out on a number of occasions earlier that reform measures must be implemented in the GCC countries. We reaffirm our belief that these measures are likely to be beneficial for the GCC countries in fulfilling their long term goal of diversification and improving the soundness of their economies.

"For many (oil exporters) it is a multi-year effort to continue with fiscal consolidation. More will need to be done in coming years to raise resources for the budget outside of the oil sector."

Masood Ahmed, the regional director for the Middle East and Central Asia at the IMF

About Alkhabeer Capital

Alkhabeer Capital is a leading asset management and investment banking firm providing world-class investment products and services that endeavors to help institutions, family groups and qualified investors access to and/or allocate capital in ways that deliver real and enduring economic value.

It is licensed by Saudi Arabia's Capital Market Authority (CMA) under license number 37-07074.

The asset management area provides investment opportunities through a large and growing portfolio of public and private funds in the areas of real estate, private equity and capital markets, while the investment banking area offers specialized Sharia compliant capital raising and M&A advisory services to businesses, private investors and families.

Alkhabeer Capital also provides advisory services on structuring Waqf entities and Waqf wealth management through its "Waqf" Program, which targets educational institutes, charitable foundations, family groups, high net worth individuals and other philanthropists who wish to establish Waqf entities.

Alkhabeer Capital has offices in Jeddah and Riyadh.

For more details on Alkhabeer Capital, please visit www.alkhabeer.com