Perspectives

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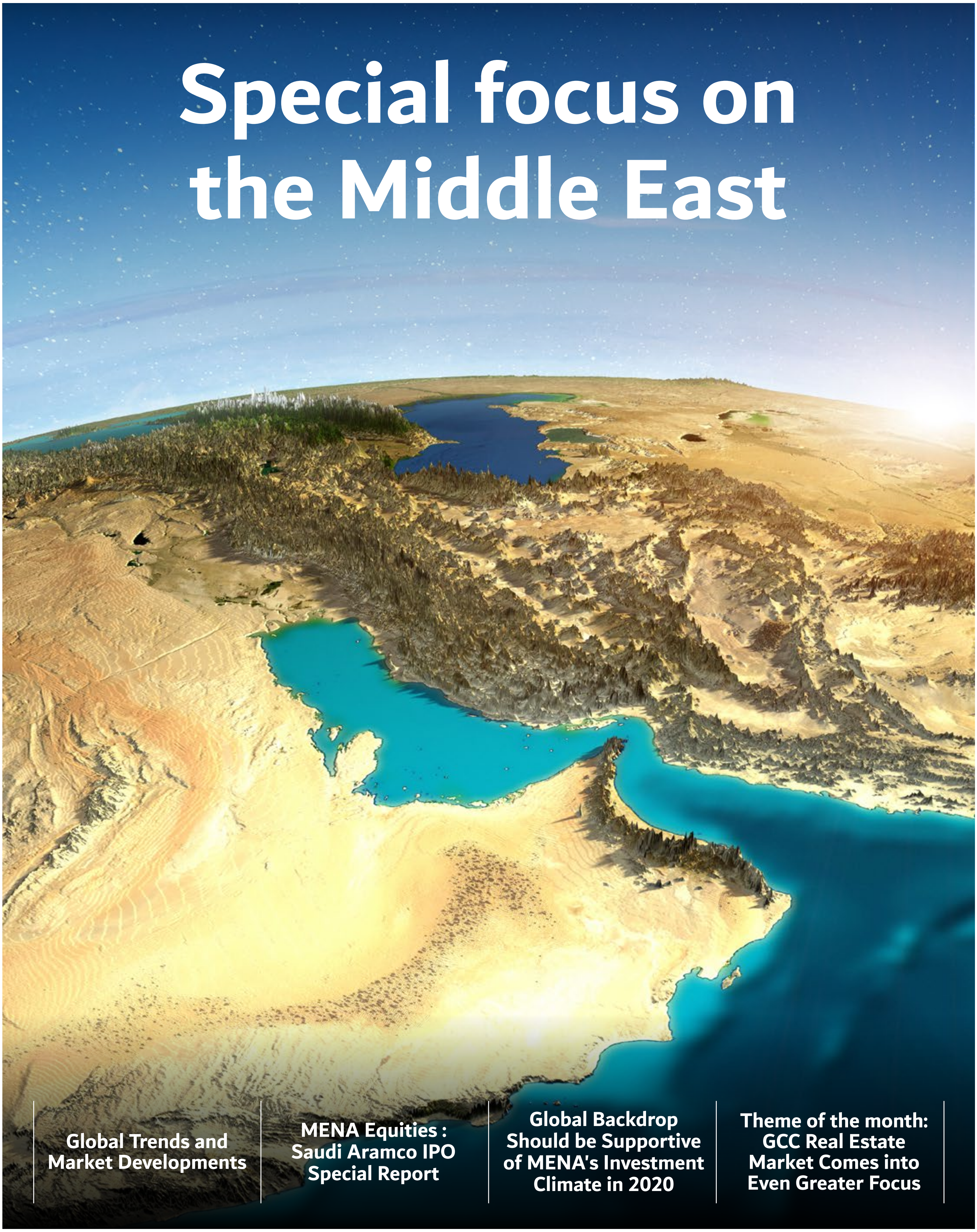
Al Mal Capital

November **2019**



Special focus on the Middle East

Global Trends and Market Developments

MENA Equities : Saudi Aramco IPO Special Report

Global Backdrop Should be Supportive of MENA's Investment Climate in 2020

Theme of the month: GCC Real Estate Market Comes into Even Greater Focus

Contents

Welcome to 30th edition of Perspectives.

The global economy continues to be stuck in a phase of sub-trend growth with trade war and monetary policy dominating the headline news. Despite this uninspiring macro-economic background, 2019 is on track to become an exceptional year for financial markets as vast majority of asset classes are up on a year-to-date basis. It is indeed a very rare occurrence when equities, long-term bonds, Gold and Oil simultaneously register double-digit year-to-date gains. In 2018, diversification didn't add much value as 95% of the asset classes ended in negative territory. So far in 2019, we are witnessing almost the opposite event as an equally weighted portfolio invested into U.S equities and US bonds is up 17% since the start of the year.

In this publication, we take a step back from global markets to focus on the recent developments which have been taking place in the Middle East and North Africa (MENA) region. Among them, the intention to float by Saudi Aramco which is expected to be the largest IPO ever. In our "deep dive" research report, we review some key facts and figures about Aramco. We look at the drivers behind this giant IPO and attempt to come up with a valuation range. We then highlight the key investment themes, risks and catalysts for Saudi Aramco stock.

In the second part of this edition of Perspectives, we look at the key global trends that could shape the economic outlook in MENA in 2020. Our theme of the month is about the Real Estate Market in the GCC.

We hope you will enjoy this issue.

#MARKET WATCH

New ECB President Christine Lagarde calls for investment stimulus

"Christine Lagarde has called on Germany and the Netherlands to use budget surpluses to fund investments to stimulate the economy, in a strong rebuke that comes just days before she becomes European Central Bank president." (source: FT).

These remarks from Christine Lagarde are significant given their timing and explicit mentioning of the countries with fiscal surplus.

QE4?

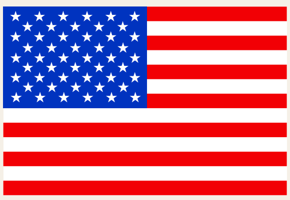
Over the last two months, the **US Federal Reserve** printed **$258 billion**, reversing six months of QT. While Powell promised $60 billion per month through Q2 2020, he is already running more than 2x that pace.

US Petroleum Trade in Surplus

The US Trade deficit fell almost 5% in September to a five-month low, aided by **The First Trade Surplus in Petroleum** since the government began keeping track in 1978. The overall surplus totaled almost $300 million. This remarkable change from being a longtime net importer of oil to a net exporter stems from a fracking revolution that has turned the U.S. back into an energy superpower.

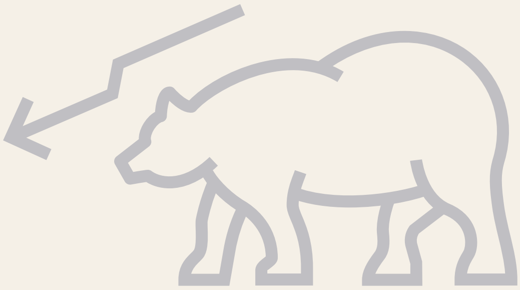
$23 trillion

$23 trillion. This is the amount of **Total US debt**. In just the past three months, total US debt increased by $1 trillion, surpassing $23 trillion for the first time.



Investors are Still Bearish

The BofAML bull & bear indicator on November 7th, 2019, suggests that investors are still bearish. Historically, it's been **positive for risky assets** such as equities and commodities.



BofAML Bull & Bear Indicator

USD 38bn

Alibaba recorded more than USD 38bn of purchases during its 11.11 (or Double Eleven) this year, exceeding last year's record of USD 31bn by 26%.

Alibaba.com™

US 3rd quarter Earnings season scorecard

(Source: Factset)

With 89% of the companies in the S&P 500 reporting actual results, **75%** have reported a positive EPS surprise and **60%** a positive revenue surprise

For Q3 2019, the **blended earnings decline is -2.4%**. It marks the 1st time the index has reported 3 straight quarters of y/y earnings declines since Q4 2015 (through Q2 2016)

For Q4 2019, **57** S&P 500 companies have issued positive EPS guidance while **22** have issued negative EPS guidance

The forward 12-month PE ratio for the S&P 500 is **17.4x**, which is above the 5-year average (16.6x)

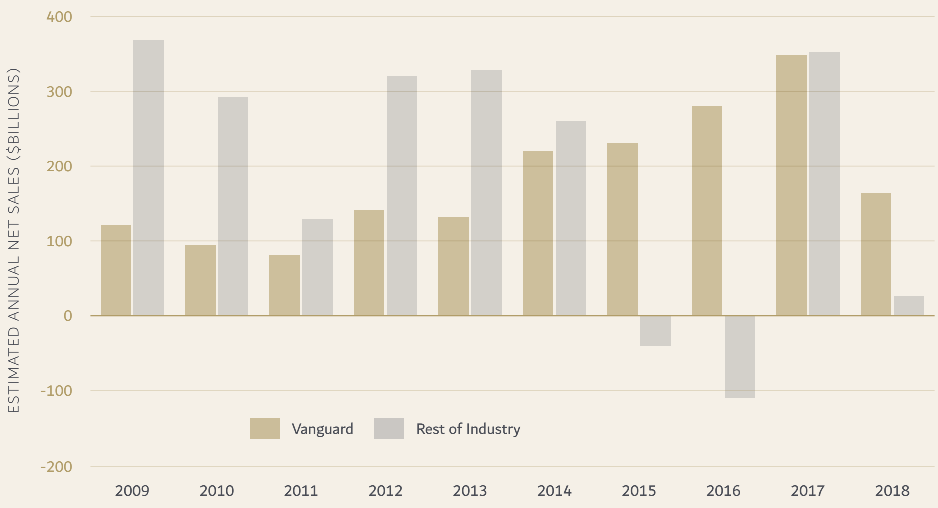
#TRENDS

Vanguard Won the Loser's Game!

Since 2014, the ETF leader firm took in $1.2 trillion of net sales, as opposed to $500 billion for all other fund companies combined. **70% of all net sales!**

All Stock and Bond Funds - Vanguard Versus Rest of Industry

Source: Morningstar Direct.



+12%

+12% is the S&P 500 **Average Returns** during Presidential Election Years

Source: J.P. Morgan

+$237.4bn

+$237.4 billion is the year-to-date inflows for all U.S-listed ETFs. This is ahead of last year's $227.8 billion pace

This ratio just hit a 50-year low

Commodities to Equities Ratio

Source: Incrementum AG.

Is "Lazy Investing" the Best Investment Strategy?

The most simple portfolio strategy (60% us stocks ETF / 40% us bonds ETF rebalanced once a year) is UP +17% YEAR-TO-DATE.

This could very well be the best year since 1997 for what is often nick-named the "lazy" or "couch potato" investment style. Over the last 10 years, this portfolio (made of 2 low-cost ETFs and which literally takes one minute per year to manage) is up +9.8% annualized with a 7.6% standard deviation. This is great news for robo-advisors but not such a good news for active managers, hedge funds and tactical asset allocators. However, past results are not a guarantee of future performance. And what if US assets outperformance against the rest of the world come to an end?

HISTORICAL RETURNS: Stocks/Bonds 60/40 Portfolio

Range	Returns (Oct 2019)	Standard Deviation
1M	+1.43%	
YTD	**+17.06%**	
1Y	+12.96%	9.78%
3Y	+10.07% *annualized*	7.35%
5Y	+7.55% *annualized*	7.22%
10Y	**+9.77%** *annualized*	**7.60%**
MAX *Dec 1986*	+8.87% *annualized*	**9.22%**

Venture Capital Mega-Deals on Peace to Set New Record in 2019

Deal Value is set to surpass $100 billion for the second year straight.

185 mega-deals ($100 million+) have already closed so far this year, nearly reaching 2018's full-year total. These outsized transactions comprise 43% of total 2019 deal value, which has continued to climb unabated to a total of $96.7 billion YTD.

$3.2B

The largest VC fund closed YTD was TCB's tenth (TCV X), which is focused on tech-enabled service companies.

VC fundraising has shifted toward increasingly larger vehicles since 2012, with 15 mega-funds closed YTD.

(Source: thevisualcapitalist.com)

8 of 5

(Source: thevisualcapitalist.com)

VC funds closed YTD were Silicon Valley based, underscoring the continued concentration of capital and investment activity.

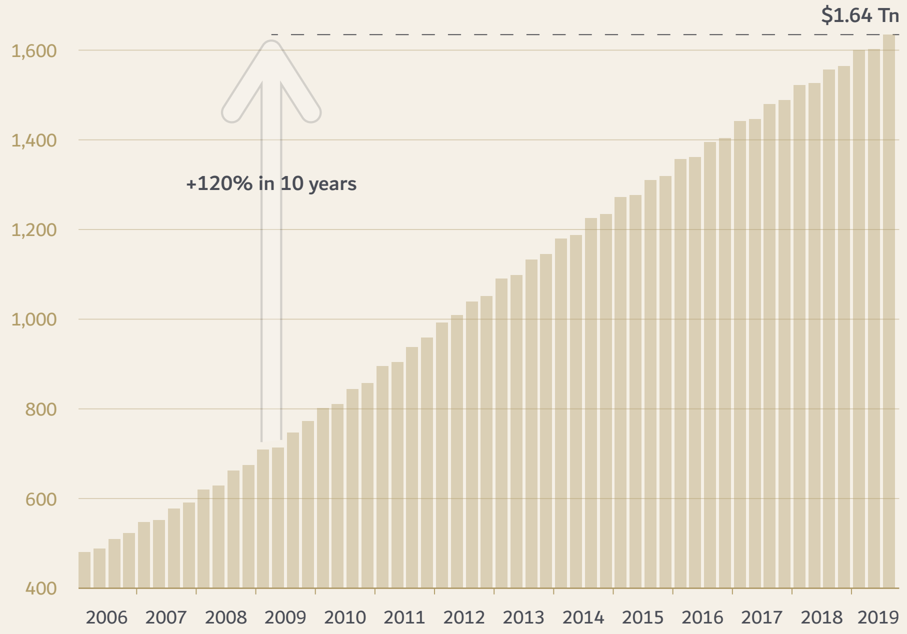
#THE BIG PICTURE

U.S Student Loans are up 120% in the Last 50 Years

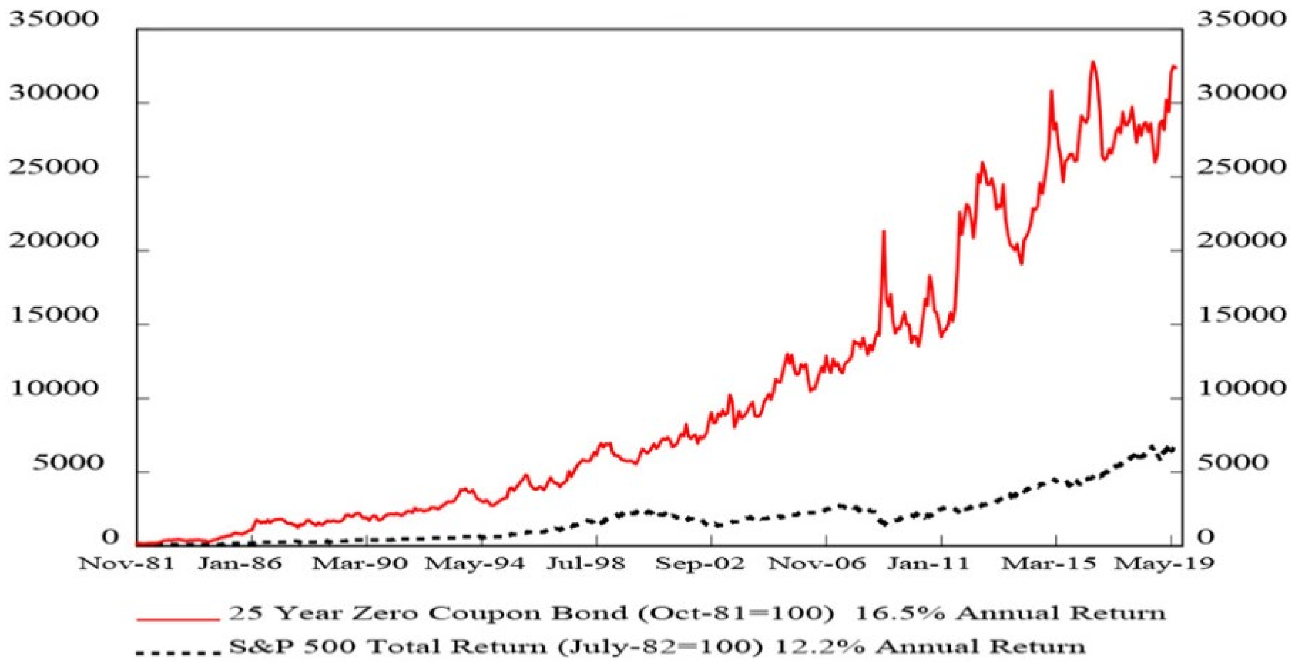
Student loans in US grew $80 billion YOY in this quarter and up 120% in last 10 years although the number of enrolment actually fell by 7% between 2010

STUDENT LOANS
Not Seasonally Adjusted, in $ billion

Source: Fed Board of Governors



The Bond rally of a lifetime vs S&P 500 - Nov 1981 - Jul 2019, in basis points.
(Source: Bourbon Financial Management)



TRADE WAR: Winners & Losers (Trailing 12-month Y/Y change in imports to the U.S)

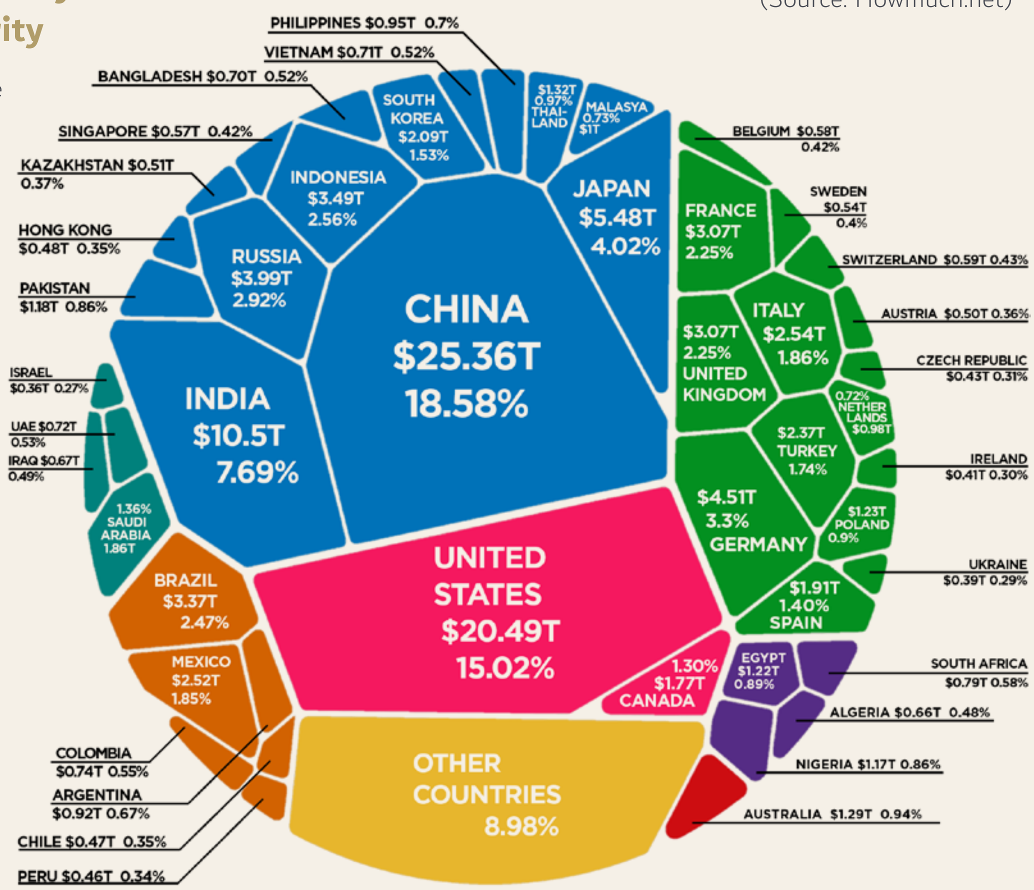
LOSERS	USD billion	USD billion	WINNERS
China	-35	23	Mexico
Venezuela	-5.2	12	Vietnam
Iraq	-4.8	8	Netherlands
Angola	-2.2	7.7	Taiwan
Nigeria	-2.0	6.5	South Korea
Hong Kong	-1.9	5.7	Japan
Spain	-1.8	5.5	UK
Israel	-1.4	4.6	Ireland
Peru	-1.3	4.2	France
Chile	-.925	4.1	India

-40 -30 -20 -10 0 10 20 30 40

The World Economy Under Price Parity

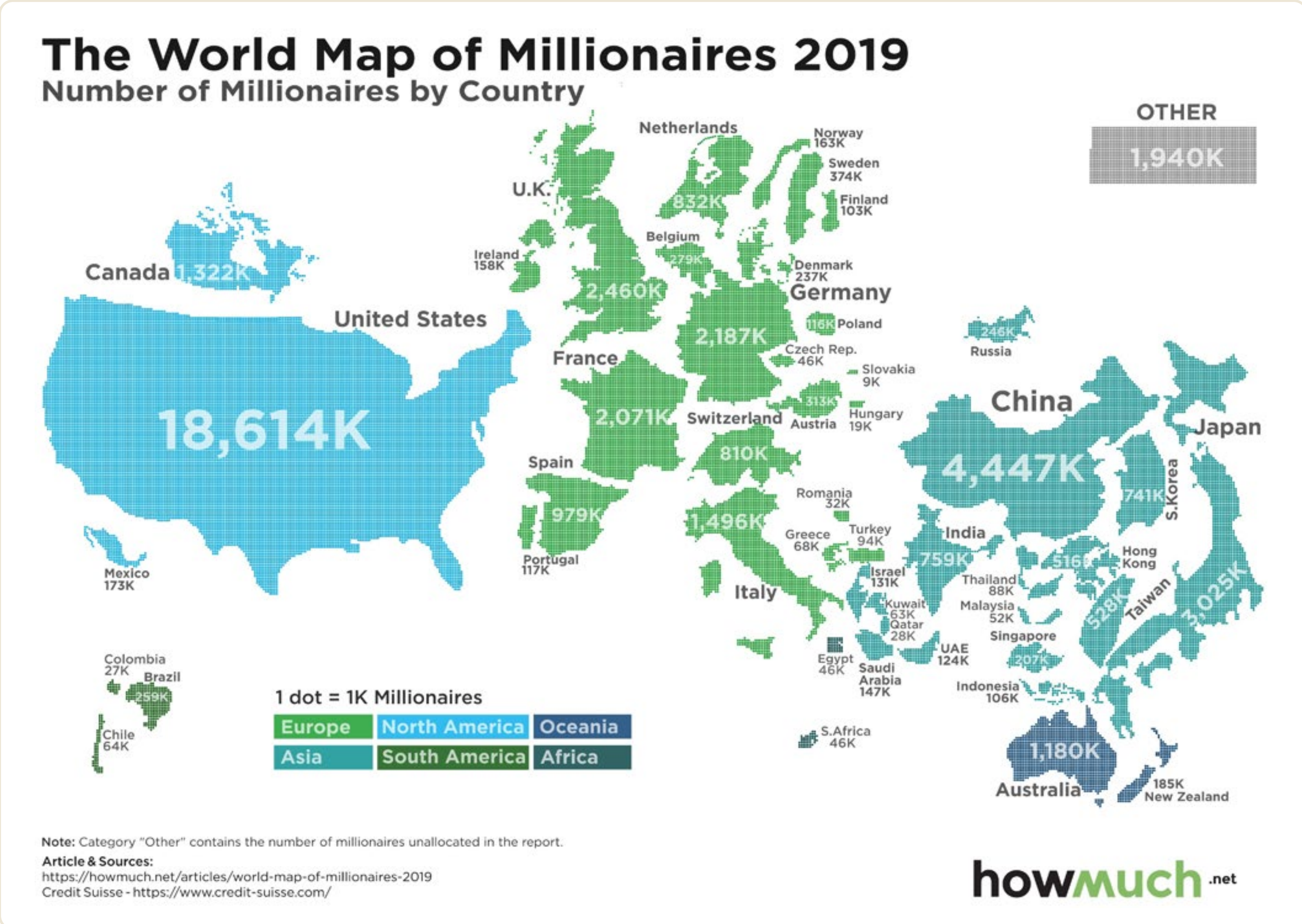
(Source: Howmuch.net)

GDP at Power Purchase Power Parity (PPP) by Country in 2018

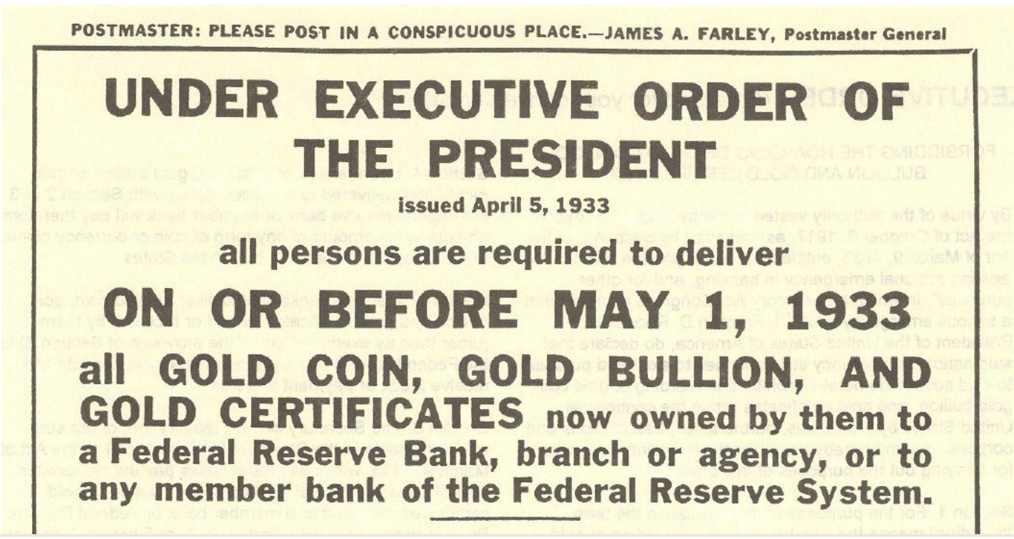


World's Region
AFRICA
AUSTRALIA
OTHER COUNTRIES
LATIN AMERICA AND CARRIBEAN
MIDDLE EAST
EUROPE
ASIA
NORTH AMERICA

#FOOD FOR THOUGHT



Can history one day repeat itself?



POSTMASTER: PLEASE POST IN A CONSPICUOUS PLACE.—JAMES A. FARLEY, Postmaster General

UNDER EXECUTIVE ORDER OF THE PRESIDENT

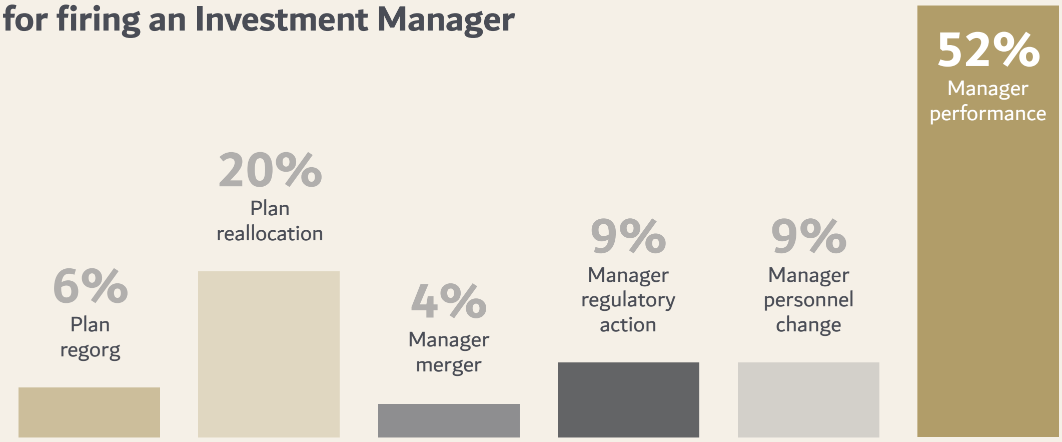
issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

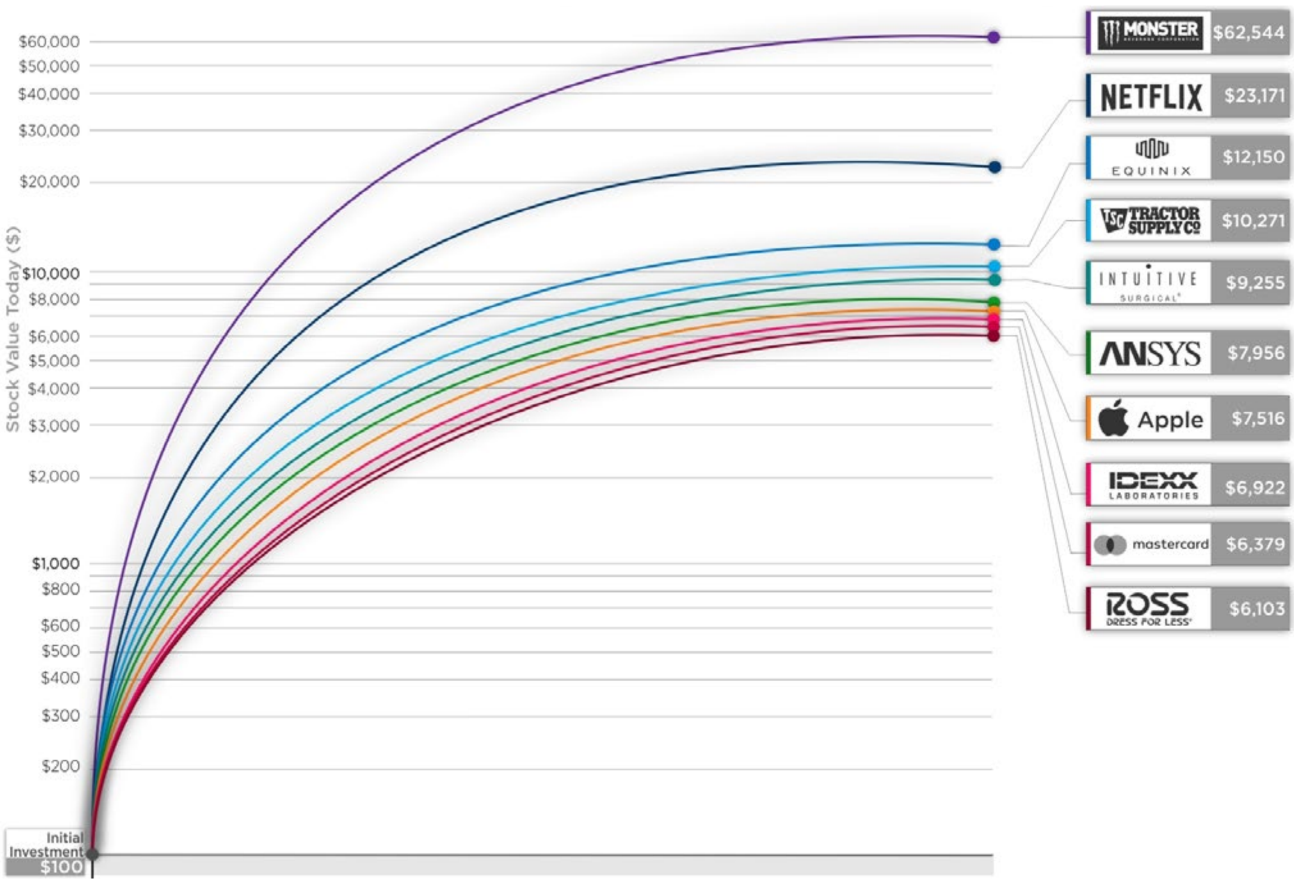
all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

Reasons given for firing an Investment Manager



Best-Performing Stocks of the Century

If you had invested $100 in 2000, what would you have today? (Source: Howmuch.net)



Saudi Aramco*

IPO

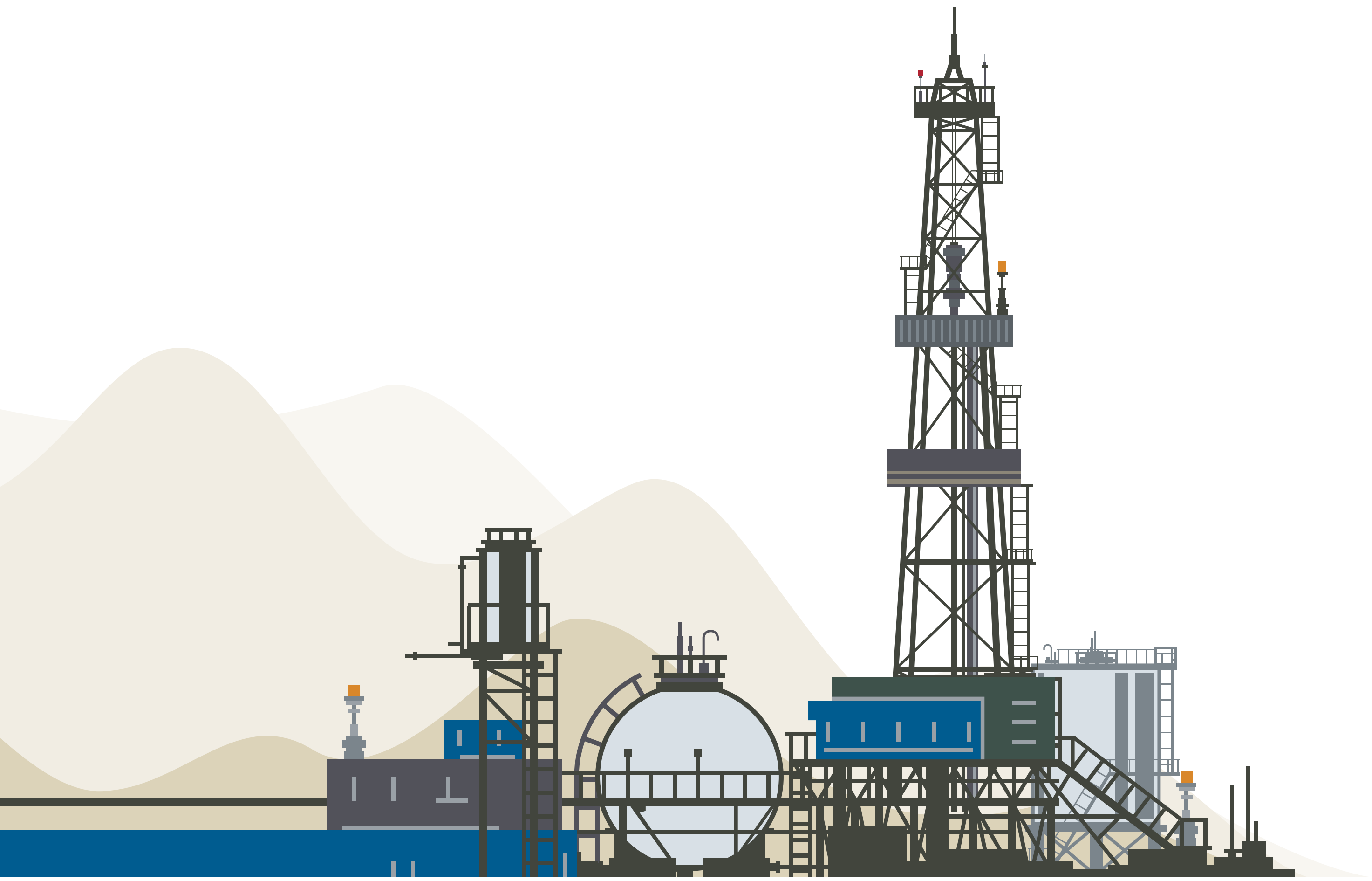
Initial Public Offering

Special Report

*Saudi Arabian Oil Company.

The world's largest oil producer, Saudi Aramco, has announced its intention to float in Riyadh on the 11th of December in what is expected to be the biggest stock market listing in history.

On the following pages, we review some key facts and figures about Aramco. We look at the drivers behind this giant IPO, as many wonder if it is an exit strategy from the fossil fuel sector by Saudi Arabia or a further step in the process of rebalancing their economy. We then discuss some estimates for Aramco reserves and expected earnings in order to come up with a valuation range. In the later section, we look at historical precedents and what could be the impact of this mega IPO on our regional benchmarks. To finish with, we highlight the key investment themes, risks and catalysts for Saudi Aramco stock.



Saudi Aramco: The Oil Colossus

History

Saudi Aramco, also called Saudi Arabian Oil Company, formerly Arabian American Oil Company, was founded by the Standard Oil Co. of California (Chevron) in 1933, when the government of Saudi Arabia granted it a concession. Other U.S. companies joined after oil was found near Dhahran in 1938.

The venture became known as the Arabia American Oil Company and crude oil production hit 500,000 barrels per day in 1949.

By 1980, the Saudi government had bought out all the original shareholders and owned 100% of the company. Eight years later, the Saudi Arabian Oil Company (Saudi Aramco) was officially established and headquartered in Dhahran.

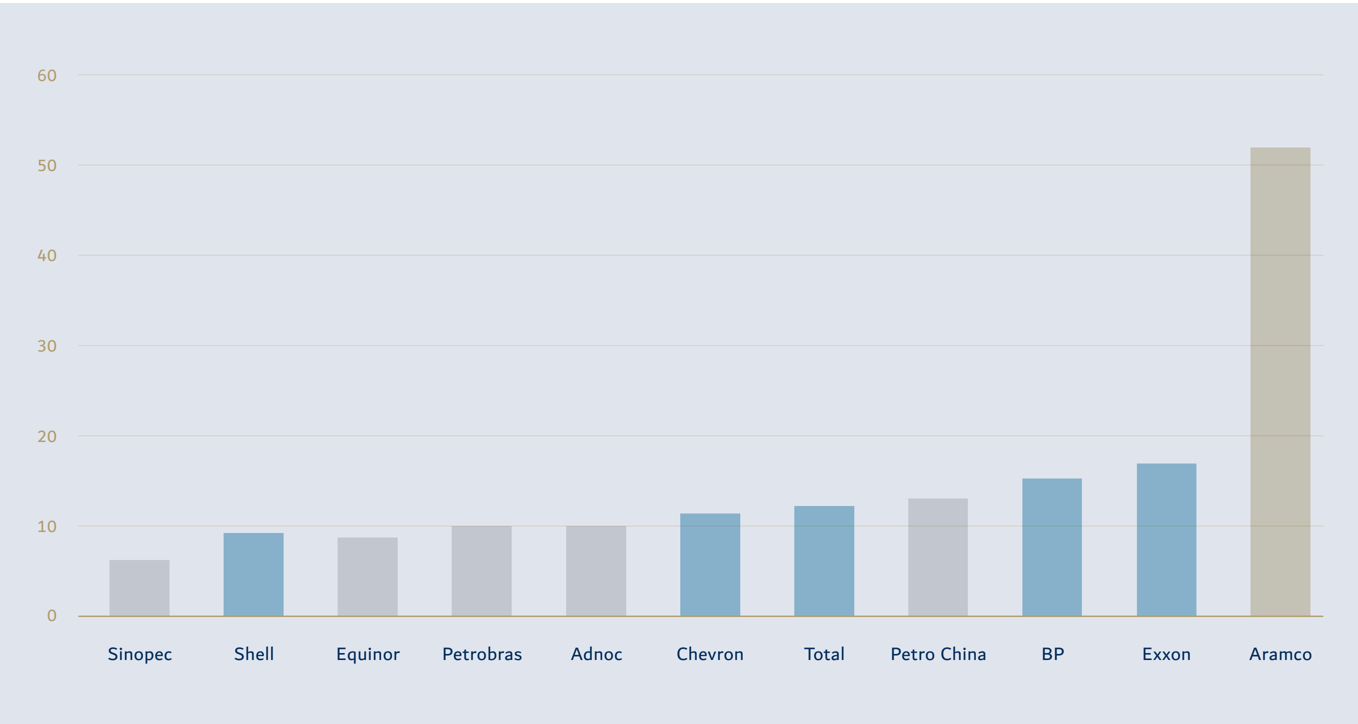
Aramco has fueled decades of prosperity in Saudi Arabia. The kingdom is the de facto leader of the OPEC (Organization of Petroleum Exporting Countries). Crown Prince Mohammed bin Salman wants to diversify the Saudi economy away from oil. Announcing plans for an Aramco IPO in 2016, he said the kingdom must end its "oil addiction" to ensure it was no longer at the mercy of commodity price volatility. Aramco has announced on Sunday 3rd of November 2019 a plan to list its initial public offering (IPO) in the domestic stock exchange (Tadawul) on the 11th of December 2019.

Oil and Gas reserves

With oil reserves of 257 billion barrels (operated via a 60-year concession), Saudi Aramco controls more than one-fifth of global petroleum reserves. It is nearly as big as Venezuela's oil reserves, bigger than Canada's oil reserves, and larger than the combined reserves of Exxon Mobil Corp, Chevron Corp, Royal Dutch Shell Plc, BP Plc and Total SA. Aramco reserves have an estimated life of 52 years (see chart below). We note that Aramco reserves have been independently verified by a consultant (*Degolyer & Macnaughton*).

Aramco also boasts nearly 294 trillion standard cubic feet (scf) of natural gas reserves.

Reserve Life in Years (Source: EFG Hermes)



Oil production at very low cost

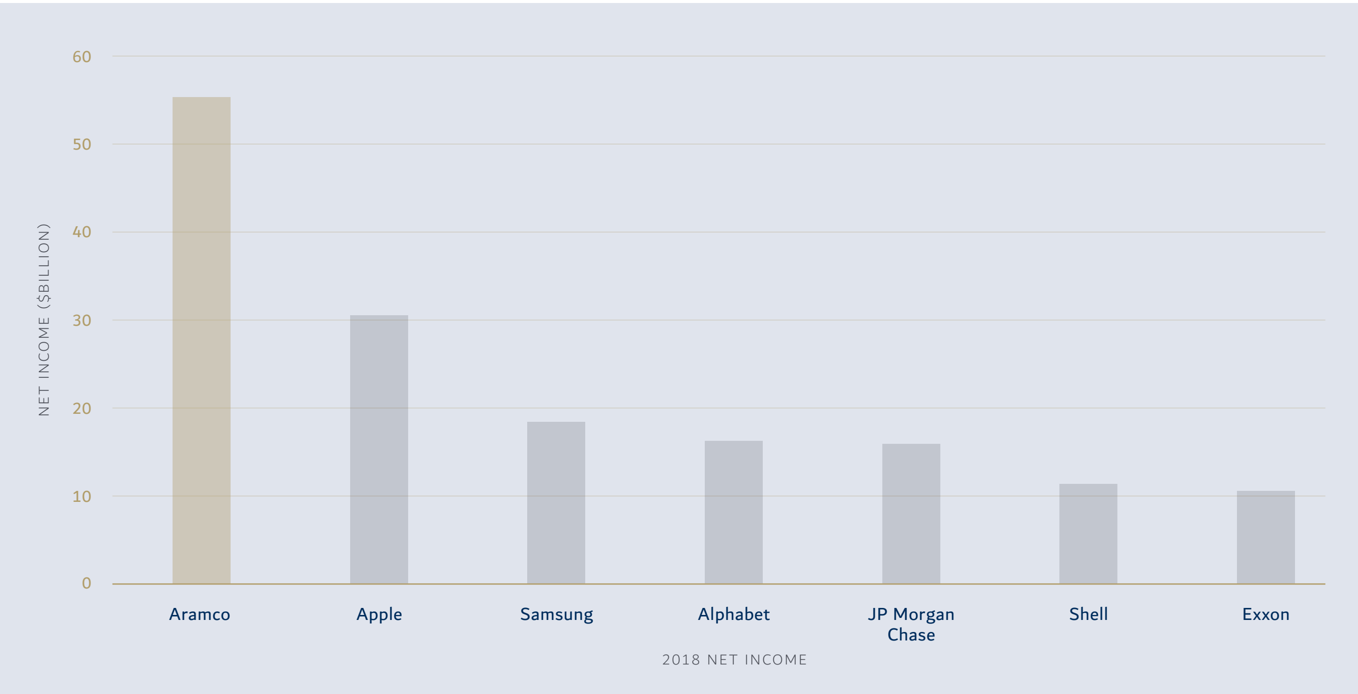
Aramco is the world's largest oil producer, contributing 13.3% of global oil supply, with around 10.3 million barrels per day of crude (versus a capacity of 12.5 million barrels per day) and around 13.6 million barrels per day of hydrocarbons sold in 2018. The size, economies of scale and unique geology of the company's fields allow it to extract oil at only $2.8/barrel lifting cost and $4.7/barrel capex costs, by far the lowest globally. Aramco has a significant competitive advantage to the $25 to $80 per barrel cost for US-based companies. Hence, the company's return on capital and free cash flow generation is multiples of what global Integrated Oil Companies generate.

Aramco also produces 1.1 million barrels of natural gas liquids and 8.9 billion standard cubic feet per day of natural gas.

Scale and unmatched returns profile

The state-owned firm generates a billion-dollar of revenues per day and is the most profitable company in the world. In 2018, Aramco reported net income at $111.1 billion compared to $75.9 billion in 2017. The 2018 net income was over a third bigger than the combined net income of the five "supermajors" Exxon Mobil, Shell, BP, Chevron and Total. It was the equivalent of 2018 profit of Apple, Google and Exxon combined.

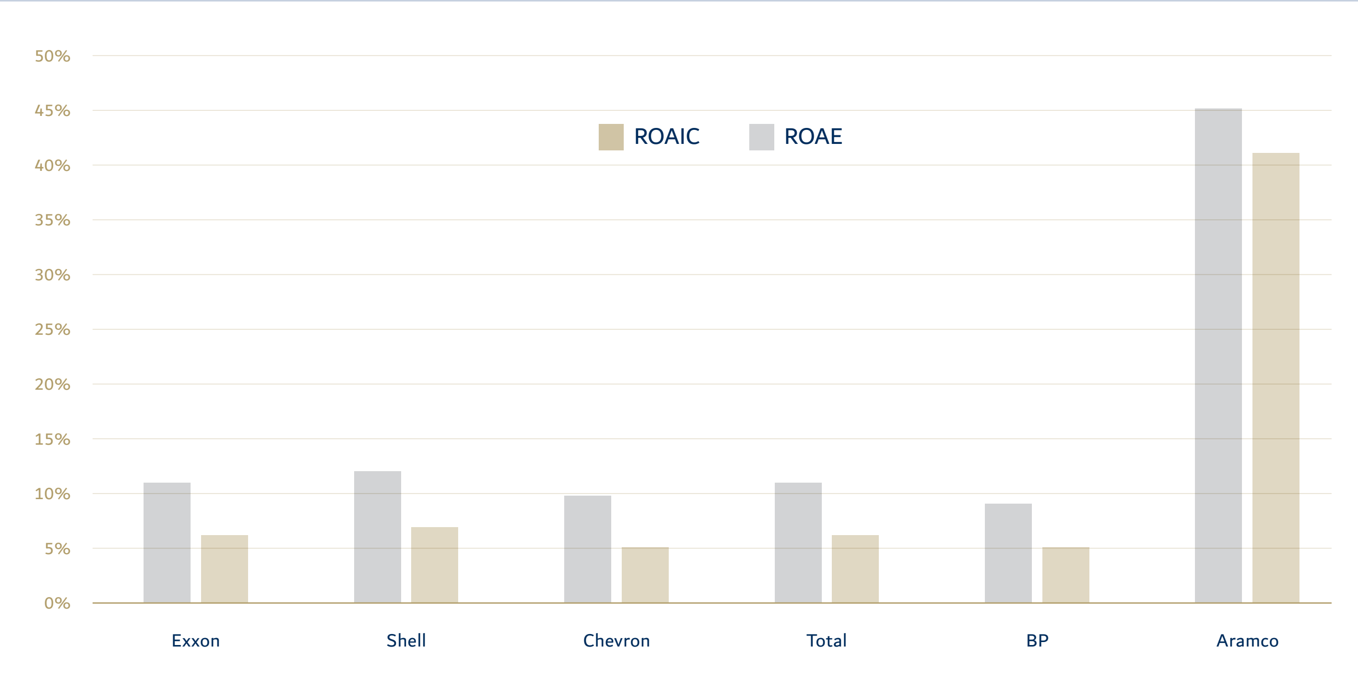
Saudi Aramco's Profit = Apple + Google + Exxon Mobil (Source: Moody's Investors Service, Bloomberg)



Saudi Aramco revenues in 2018 were $355.9 billion. Aramco reported a net income of $46.9 billion for the first half of 2019.

Aramco's return on capital is multiples of what global Integrated Oil companies (IOCs) peers generate. In 2018, Aramco's return on adjusted invested capital (ROAIC) was 41% versus 5.9% for the world's top five IOCs. Aramco's return on adjusted equity (ROAE) stands at 45%, which is also way above the peer group (see chart below). Should Oil prices hover around $60 per barrel, Aramco is positioned to generate more than $200 billion EBITDA.

Aramco Returns Far Surpass Peers (2018 numbers; Source: EFG Hermes)



Should Oil prices hover around $60 per barrel, Aramco is positioned to generate more than $200 billion EBITDA.

With 76,000 employees in 2018, Aramco has energy industry operations, research facilities and offices scattered across the globe, in Asia, Europe and the Americas. It has country offices in Beijing, New Delhi, Singapore, New York, London, Houston and elsewhere.

Aramco plans to invest $334 billion over the next 10 years to sustain oil production: 42% will be on drilling, 31% on facilities and 11% on infrastructure. In April 2019, Aramco tapped debt markets for $10 billion to finance this program. This first-ever international bond sale by Saudi Aramco received bids for more than 10 times the $10 billion it was expected to raise.

Aramco has significant influence on how the official selling price (OSP) of crude oil is determined – calculated by adding a differential to a specific crude oil benchmark price depending on the location of a customer and quality of crude oil being considered.

Aramco is obviously a huge contributor to Saudi Economy. The state-owned oil producer alone contributes to 45% of Saudi Arabia's GDP, 90% of the country's export revenues, and almost 80% of budget revenues.

Aramco is the largest company in Saudi but also a benchmark for the Kingdom. Indeed, not only does the state-owned company employ a huge number of people, but it is also seen by many as a model for a more dynamic and open society which MBS is trying to promote.

The company prides itself on hiring the best and brightest young Saudis – a symbol of meritocracy in tribal culture. It strives for the highest standards of operational excellence, has a multinational workforce and has accounting and government structures similar to the biggest international oil majors. In the Dhahran compound, men and women work side by side.

Oil exports

Almost three-quarters of Aramco's crude exports, about 5.2 million bpd, were delivered to customers in Asia last year, where Aramco believes that demand will grow faster than elsewhere in the world. Its Asian buyers include China, India, South Korea, Japan and Taiwan. Its crude deliveries to North America reached more than 1 million bpd last year; to Europe, 864,000 bpd.

Downstream Assets

Saudi Aramco is not only an upstream giant, but it also owns some downstream assets such as the Sadara Chemical Company - a $20 billion JV with Dow Chemical - and the largest chemical plant ever built in one phase. Over the last years, Saudi Aramco has been increasing its investments in chemicals. The Sadara uses oil and gas to produce a range of specialty chemicals found in everything from cosmetics to car parts. This plant exemplifies Aramco (and indirectly the Saudi government) drive to develop higher value industries such as petrochemicals, which can be built on rather than replace the kingdom's natural resources. Aramco Top management portrayed the Sadara plant as a demonstration that Saudi Aramco can become an ally of economic diversification instead of an obstacle.

A global refining expansion is another long-term play for Aramco. The state-owned company already operates international and domestic JVs in refining such as Motiva (partner: Shell) or Saudi Aramco Total Refining and Petrochemical (partner: Total). By acquiring stakes in foreign refineries, the company is banking on locking in buyers for the Kingdom's crude in fast-growing markets such as China, India and Indonesia. Aramco exploration program is one of the biggest in the world and the action of adding more gas, more chemicals is a demonstration of their actions.

The expansion into downstream assets by Aramco shows that Saudi leaders understand that until now, they have been losing tremendous value by exporting commodities and importing finished products in which all the value is contained. The focus on petrochemicals shows how the "new economy" promoted by MBS remains linked to the country's oil. In some ways, exploiting and preserving their main resource – at least over the next 20 years – and using that income to develop entirely new sectors seems indeed like a wise strategy.

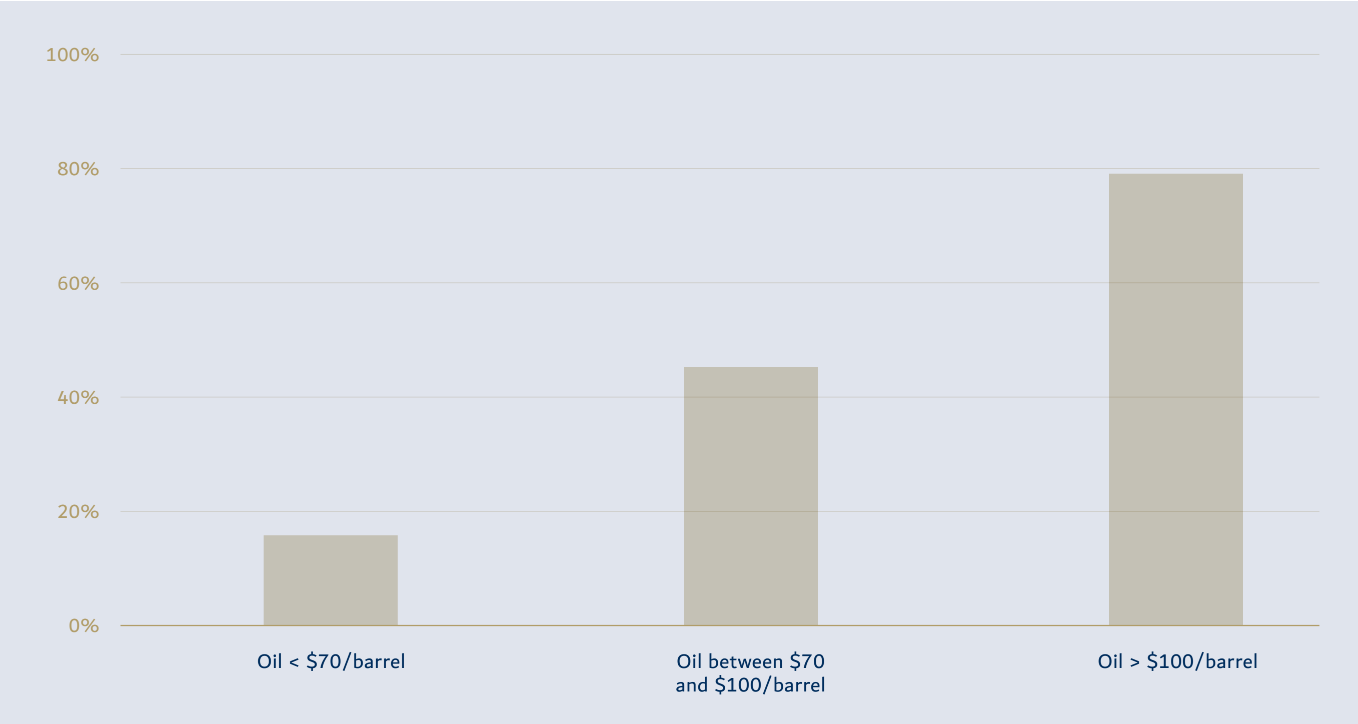
Understanding Aramco's fiscal regime

Royalties: a new structure that limits the upside but protects the downside

Ahead of the IPO, the government has changed the royalty structure and will do it again in January 2020 in order to attract investors at the lower end of oil prices. The effective royalty when oil prices are below $70/barrel will decrease from 20% to 15%. While this structure reduces the downside for equity holders in a weak oil price environment, it also limits the payoff on the upside in a bull case scenario, making Aramco more of a defensive name along oil plays.

Another defensive feature is the fact that the company can offset receivables with taxes, which essentially guarantees that the company will be paid in full in a timely manner.

Absolute Royalty Rate (Post adjustment as of January 2020)



A 50% tax rate offer lucrative returns to the Kingdom of Saudi Arabia

Aramco has special tax arrangements within Saudi Arabia and is the main source of tax income for the government. In the years ahead of IPO date, Aramco's tax rates have been cut for its upstream business in 2017 from around 80% to 50%. The fully-owned downstream operations are subject to a roughly 20% tax rate. Dry gas operations do not pay taxes.

As of 2018, Aramco's tax bill was $102 billion. It is estimated that Aramco's tax bill will continue to expand in line with EBIT growth. In percentage terms, the tax rate is expected to stay flat at around 49%.

A closer look at Aramco Financials

While the upstream business makes the bulk of revenue and earnings for Aramco, Aramco's pricing-related growth prospects could be limited if oil prices remain range-bound at $60-65/barrel. Moreover, a major ramp-up in crude production is not expected in the medium term.

However, Aramco has positioned itself to increase production and raise its market share through purchasing equity stake in a number of existing and Greenfield refineries. This should enable Aramco to increase revenue growth rate and absorb upstream crude volumes. According to EFG Hermes, Aramco's hydrocarbon production is expected to grow at a CAGR of 3% between 2019 and 2023e in order to feed its increasing downstream needs.

As such, Aramco's EBITDAX (earnings before interest, taxes, depreciation/or depletion, amortization, and exploration expense) and net income are expected to grow at around 9% per annum from 2019 through 2023e, mainly thanks to

1 Higher gas production volume;
2 Expansion of the company's refinery assets;
3 Consolidation of SABIC and
4 Fiscal regime changes. A marginal increase in crude volumes is also expected.

Taking into account the company' low cost structure (royalties of around 15% if oil prices stay below $70 and lifting costs at $2.8/barrel of oil extracted), as well as expectations that around 45% of the company's volume is secured, Saudi Aramco is expected to generate more than $200 billion of EBITDAX in 2020e unless Brent oil prices drop below $60 per barrel.

Aramco Income Statement & Financial ratios (Source: EFG Hermes)

IN USD BILLION (UNLESS STATED OTHERWISE)	2016	2017	2018	2019e	2020e	2021e	2022e	2023e
Daily production	13.6	13.2	13.6	13.3	13.7	14.3	14.5	15.2
Sales volume (upstream + downstream) in billion barrels	5	5.2	5.4	5.4	5.6	5.8	6	6.2
Average Brent oil prices	45	55	72	63	65	66.3	67.6	69
Revenues	**134.6**	**264.2**	**355.9**	**311.7**	**365.5**	**401.9**	**420.4**	**439.6**
Royalties	0	(38)	(56)	(46)	(36)	(37)	(39)	(40)
Open (ex SG&A)	(17)	(16)	(16)	(18)	(33)	(48)	(49)	(52)
Exploration	(3)	(4)	(2)	(2)	(3)	(3)	(3)	(3)
Purchases	(14)	(14)	(14)	(14)	(14)	(14)	(14)	(14)
D&A	(9)	(10)	(11)	(13)	(16)	(19)	(21)	(22)
Gross Profit	91.4	163.7	221.2	181.4	222.1	238.1	249.2	260.3
EBITDAX	93	169	226	187	227	243	254	266
EBIDTA	90	165	224	184	224	240	252	263
Operating Income EBIT	**81.5**	**155.4**	**212.9**	**171.8**	**208.5**	**220.8**	**230.9**	**240.9**
Net Income before tax	81.3	155.1	212.8	171.1	207.5	219.9	230.3	239.4
Texes	(68)	(79)	(102)	(82)	(98)	(103)	(107)	(111)
NET INCOME	**13.0**	**76.0**	**111.0**	**89.0**	**108.0**	**114.0**	**119.0**	**124.0**

RATIOS								
Gross Profit margin (in %)	67.9%	62.0%	62.2%	58.2%	60.8%	59.2%	59.3%	59.2%
EBIDTA margin (in %)	66.9%	62.5%	62.9%	59.0%	61.3%	59.7%	59.9%	59.8%
EBIT margin (in %)	60.5%	58.8%	59.8%	55.1%	57.0%	54.9%	54.9%	54.8%
ROAE	13.0%	37.0%	45.0%	32.0%	36.0%	35.0%	33.0%	33.0%
ROAIC	14%	37%	47%	34%	33%	29%	29%	29%

Aramco Free Cash Flow

Because of a 50% tax rate and a substantial amount of growth capex, Saudi Aramco has a low rate of conversion of EBITDA to Free Cash Flow from Financial Financing.

With over $100 billion in sustainable free cash flow ($75 billion including growth capex) and a net cash position (see below), Aramco has substantial room to pay out dividends to investors. Moreover, dividends are expected to grow at a 10% CAGR between 2019 and 2023e.

Low debt balances

The size of Aramco's Balance Sheet as of the end of 2018 was $359 billion of which $49 billion was gross debt. While the amount of gross debt might sound elevated, it is worth keeping in mind that this amount is equivalent to its semi-annual operating cash flow. The company has a net cash position of current USD 6 billion when taking account short-term investments (mainly time deposits). Going forward, the management expects to increase leverage and targets a gearing ratio of 5-15% (net debt / net equity).

Aramco IPO

In early 2017, Saudi Aramco announced its intention to IPO the company for the first time ever. The announcement came as a surprise to many. The IPO was delayed several times reportedly due to his dissatisfaction with the valuation of the firm, which fell short of the hoped for $2 trillion. But on the 3rd of November 2019, Saudi Aramco announced the plan to list its IPO in the domestic stock exchange (Tadawul). The IPO prospectus will be issued on 9 November 2019 whereas the trading in the local exchange Tadawul is expected to be on 11 December 2019. The size is expected to be 1.5% of the company shares so by assuming a range of $1.6-$1.7 trillion total market capitalization, proceeds from the Aramco sale should be between $24bn to $25.5bn.

Being the largest oil company in the world with presumably the largest reserves and lowest production costs, the reasons behind the IPO continue to be of interest.

In the next section, we explore the main drivers behind this IPO.

An Oil Giant

Saudi Aramco has petroleum operations that cut across the industry.

SOME OF ARAMCO'S OPERATIONS BY TYPE:

Oil Production
Upstream Assets

257

billion barrels of proved conventional oil reserves

12.5

million barrels a day production capacity

10.3

million barrels a day production

Petrochemical
Downstream Assets

Sadara Chemical Company
A $20 billion 50/50 joint venture between Aramco and Dow Chemical. Located in Jubail. World's largest chemical plant ever built in one phase. IPO expected in 2016.

Source: the company
The Wall Street Journal

Refining
Downstream Assets

INTERNATIONAL JOINT VENTURES

Motiva | **Partner: Shell (U.K/Dutch)**

1.1 million barrels a day capacity

S-OIL | **South Korea**

0.67

DOMESTIC JOINT VENTURES

Saudi Aramco Total Refining and Petrochemical | **Total (France)**

0.40

Yanbu Aramco Sinopec Refining | **Sumitomo (China)**

0.40

Yanbu Aramco Sinopec Refining | **Sumitomo (China)**

0.40

DOMESTIC WHOLLY OWNED

Ras Tanura

0.55

Jizan

0.40

The size is expected to be 1.5% of the company shares so by assuming a $1.6-1.7 trillion valuation, proceeds from the Aramco sales should be between $24bn to $25.5bn.

Aramco is likely to become the World's biggest company by far (1.5 times the size of Apple Inc.).

Why an IPO?

So why would the Gulf country go public with one of its best state-run firms that also gives it the power to become the swing producer in the global oil market?

At an early stage, there were suggestions that Saudi Aramco could choose a more cautious route of 'listing of a bundle' of refining subsidiaries and other downstream assets. But over time, the signals became stronger in favor of an IPO of a minority stake (initially 5 percent) in the entire company including upstream.

The main drivers behind the IPO have also evolved. In the early stages, the objective of the IPO was focused on the company to showcase Saudi Aramco and make it part of the global capital markets, unleash the company's capabilities, allow it to expand internationally and to remove this notion that Saudi Aramco is not transparent. That aim is similar to the objectives of international listings of other countries' state-owned enterprises and other corporations.

According to a blog post written by Yasser Al Saleh, senior research fellow at INSEAD Innovation and Policy Initiative, this IPO also conveys a broader message to the economy. Listing Aramco is not about raising money as such; it is more a bold political message that no sector is immune from privatization.

However, while the aims mentioned above might be relevant, we do see them as secondary ones. Indeed, we do believe that privatizing Aramco is first and foremost a key milestone for the economic shakeup announced by MBS in order to wean the local economy of petrodollars and to better diversify the national income. The need to reform the economy gained urgency when Brent plunged from $100 a barrel on average in 2010 to less than half that amount in 2014.

Proceeds from the Aramco sale — which could range between $24bn to $25.5bn will be diverted to the Public Investment Fund (PIF) which is expected to act as a cover for post-oil days for Saudi Arabia.

Indeed, the Crown Prince has floated the idea of forming a $2 trillion megafund, likely to be funded by the Aramco IPO proceeds. The aim of the fund is to achieve a level of nearly 50% of its total investments in foreign assets and invest into new industries ranging from technology to mining, thereby shifting the economy's dependency away from oil. This is a key aspect of the Vision 2030 plan.

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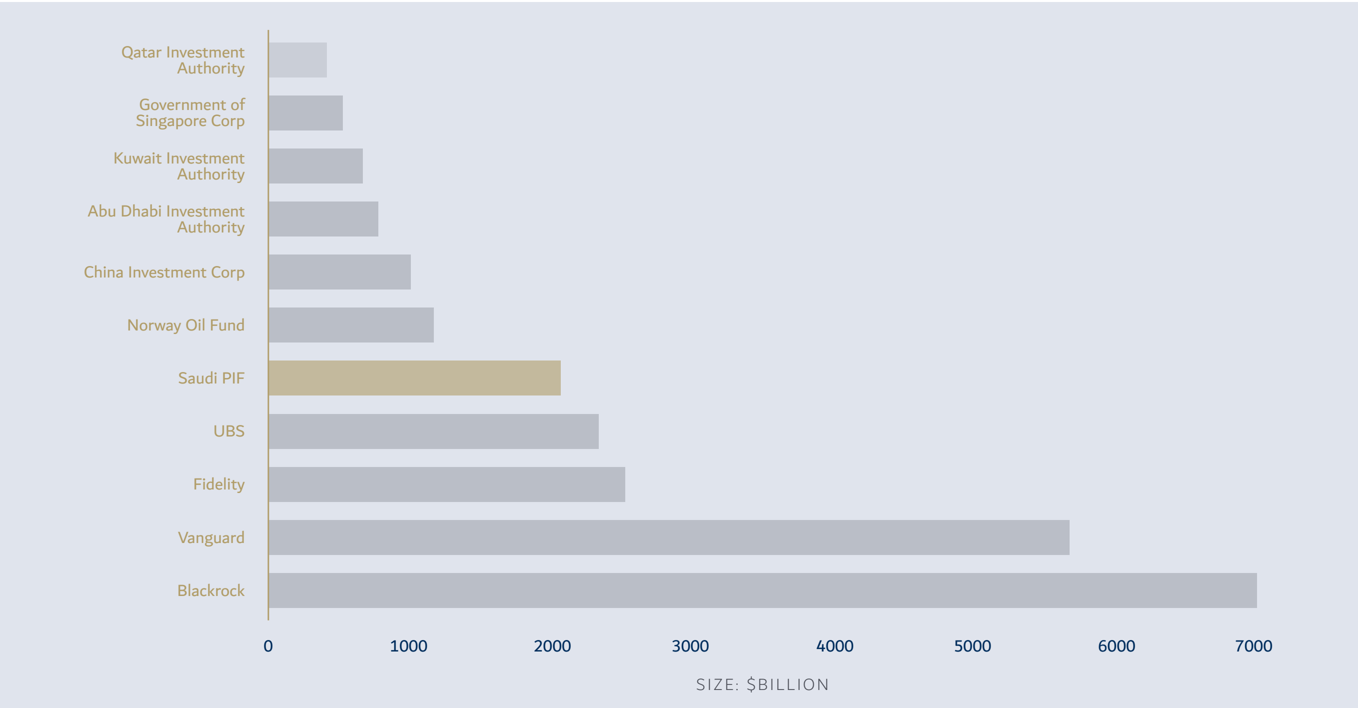
How Would the Saudi Public Investment Fund Stack Up? (Size in USD billion)



From an objective point of view, it does not seem that the Sovereign Wealth Fund (SWF) idea is much about "real" economic diversification (which is often associated with expanding the economic base and job creation). We do think that the fund is mainly about income diversification and boosting the financial resources available to the kingdom. As the experience of neighboring countries has shown, sovereign wealth funds predominantly diversify their assets by investing in foreign markets rather than in diversification of the domestic economy into employment creating sectors.

The recent deal between Soft Bank and the PIF to launch one of the largest tech investment funds in the world could be an indication that most of the investments will be allocated towards technology sectors outside the Kingdom, with limited impact on the real economic structure of the economy. According to a recent report, PIF has already channeled about $50 billion into investments abroad, the bulk of it into technology with some warning that there is 'a risk that PIF are chasing the bright lights', and instead 'they need to pay attention to valuations'.

Another key objective of many SWFs in the region is to earn the government a higher rate of return than on foreign exchange reserves since their investment mandate emphasizes high risk-return profile. From our point of view, the rate of return on foreign exchange reserves should not be the benchmark for comparison. Indeed, it would be legitimate to consider financing Vision 2030 from borrowing on global debt markets.

Last year, Saudi Arabia managed to raise $17.5 billion in the biggest ever bond sale from an emerging market (the offer was oversubscribed) with very attractive rates with the 10-year note yielding a spread of 165 basis points above the US benchmark. It would thus be legitimate to compare the discount rate used for the Aramco IPO with a risk-adjusted cost of borrowing when it comes to finance Vision 2030.

The IPO of Saudi Aramco also reflects a more fundamental question about the future role of the Saudi Energy sector. As recently emphasized by MBS, "Oil should be treated as an investment, nothing more, nothing less. It is an investment. [Saudi Aramco] is a company that has a value…You must own it as an investment. It should not be owned as a primary commodity or a major source of income…The income of the kingdom of Saudi Arabia will be generated from investment instead of oil. Technically on paper, our income will be provided by investment".

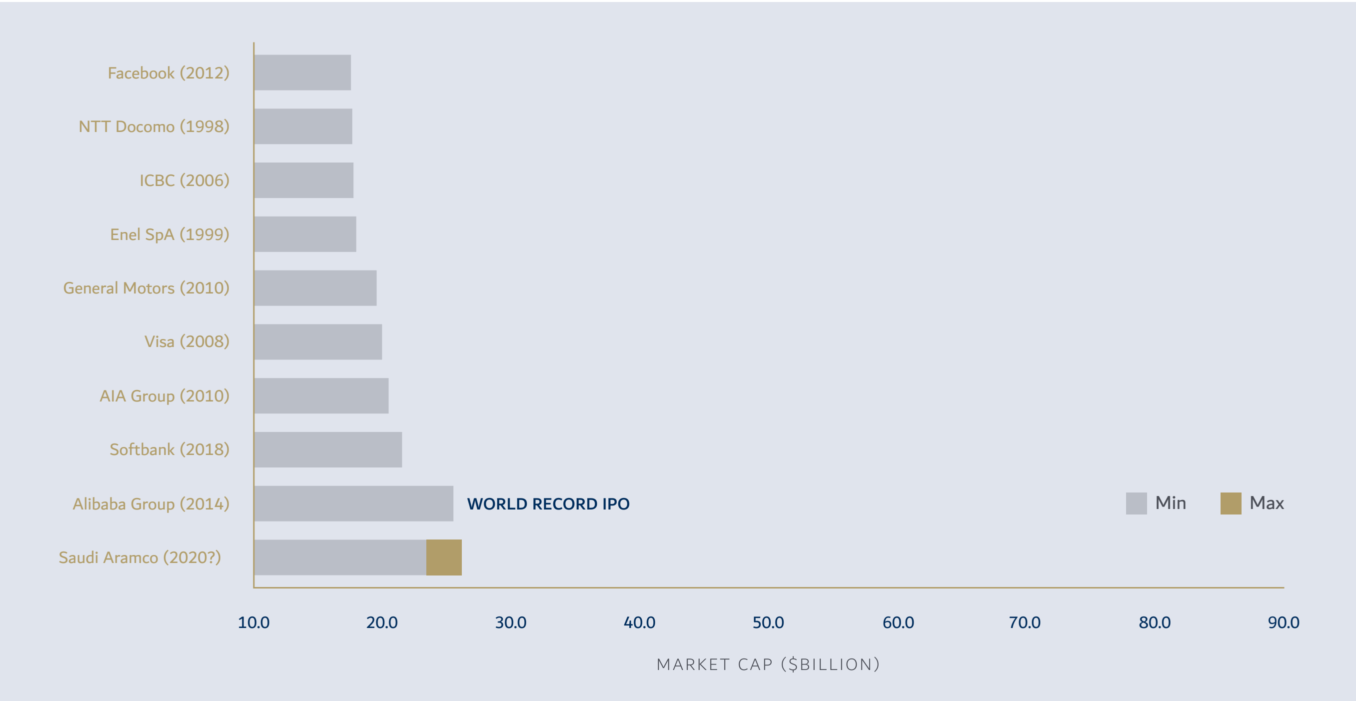
This view represents departure from past thinking where the oil sector was seen as a major source of income, the bedrock of the economic and political stability of the country, and a key sector to promote diversification and industrialization and add value to the economy. But this new way of thinking also implies that the ultimate success of the IPO of Saudi Aramco will be linked to the quality of the investment decisions and whether the investment proceeds of the partial sale of Aramco will be used to transform the Saudi economy.

For How Much?

With an estimated market capitalization between $1.6 trillion and $1.8 trillion, Aramco would become the World's biggest company by far - 1.5 times the size of Apple Inc.

With the size expected to be 1.5% of the company shares and by assuming a US$1.6 -$1.7 trillion valuation, proceeds from the Aramco sale should be between $24bn to $25.5bn. As such, it would be equivalent or slightly above the $25 billion world record IPO by Chinese Internet retailer Alibaba in 2014 (see chart below).

The World's Biggest IPOs (Estimates for Aramco share sale have ranged from $24bn to 25.5bn)



There has been much skepticism about the $2 trillion valuation initially put forward by MBS. In order to secure the highest valuation as possible in the long run, Aramco will have to reassure investors on two key pieces of information: 1 the size of its oil and gas reserves and; 2 its current and future financial performance.

Aramco's size of its oil and gas reserves

Based on Aramco's oil reserves of 257 billion barrels and a valuation of $7 to $8 per barrel in line with recent industry acquisitions – such as Total's purchase of Maersk's oil assets – Aramco warrants close to the $1.8 - $2 trillion valuation.

Presumably, the country's 298 trillion cubic feet of natural gas, equivalent to 49 billion barrels of oil, should also be included.

The Five Large Integrated Oil Companies trade at an average EV/reserves 2018 of 15.8x. At a $1.7 trillion market capitalization, Aramco trades at 5x EV/Reserves 2018, which is a very steep discount. Applying the average EV/reserves multiple to Aramco reserves implies an astronomical $5.4 trillion valuation...

However, there has been much confusion as to whether the underground reserves will continue to be owned by the State following the IPO. This debate is rather redundant, as what matters is the type of agreement between the State and the operator, which, in the case of Saudi Arabia, is based on a concession agreement. Like any other concession, the holder is given the right to exploit and monetize the underground reserves in return for payment of taxes and royalties to the government.

Why Aramco cannot be compared to other major Integrated Oil Companies

No matter how much oil and gas Aramco oversees, the earnings rather than the assets will matter more to the market. As recently put by Total's CEO, the value of an oil company is 'not a multiplicator of the reserves of the company'. Instead, the company should be valued based on models that discount future cash flows, which depend primarily not only on the quantity of oil produced but also on the profit per barrel.

The profit per barrel, in turn, is highly sensitive to the level of taxes and royalties that the government imposes on Saudi Aramco; if the taxes and royalties are high, then the valuation will be low and vice versa. Based on the old system of a royalty of 20% and taxes of 85%, many have shown that the valuation will be far less than the $2 trillion number put forward by MBS.

For instance, based on a price of $70 per barrel, production of 10 million barrel per day, a production cost of $8 per barrel, 20% royalty payment, an 85% tax rate, and a 70-year production period, Boslego calculated the net present value of the company only at $251 billion at a 10% discount rate. To achieve a higher valuation, the government has recently cut the tax rate to 50%.

Since valuation depends on the tax rate applied to future production it will be affected by Saudi Arabia's public finances, which are already strained by lower international oil prices over the recent years. However, taxes and royalties are not the only contributions to the Kingdom's finances from Saudi Aramco. The reduction in tax rate designed to support the IPO valuation could be partially offset by, for example, Saudi Arabia calling for maximum dividend payments on a more frequent basis.

While this is good news for investors, seeking large dividends, it undermines Saudi Aramco's ability to retain funds inside the company and would disrupt the government's existing stable cash flow streams based on royalties and taxes in favor of uncertain streams of income.

As the Kingdom changes from an era of buoyant revenues to one where social and developmental expenditure is subject to tight budget constraints, a tax rate of 50 percent or lower may not be sustainable. Therefore, the government by reducing the tax to lower levels in support of the IPO may not necessarily achieve the desired higher valuation, as investors recognize the unsustainability of a lower tax regime will reduce the shares' valuation by applying a higher discount rate to the stream of cash flows.

The government could enter into legally binding contracts to fix tax/royalty rates to show its firm commitment to low taxation, but these commitments are not credible in the long-term and will expose the company (and the country) to unnecessary legal risks, and most importantly will undermine the sovereignty of the State by giving up on a fundamental power to adjust taxes.

As highlighted in a report by the Oxford Institute for Energy studies, this discussion highlights a key fact: the IPO of Saudi Aramco cannot be isolated from transformations in the rest of the economy and there are key trade-offs that the Saudi decision-makers can't ignore. For instance, reducing the tax and royalty rates on Saudi Aramco would increase the company's valuation, but would substantially squeeze government finances, which still rely heavily on oil revenues.

Therefore, the economy needs to adjust to lower oil revenues, by boosting non-oil revenues, cutting current and capital spending, borrowing from local and international markets, and above all diversify the economic base, which according to the current leadership can only be achieved through a successful IPO of Saudi Aramco. This reflects clear circularity in approaching the fiscal sustainability issue.

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An EV/EBITDA valuation approach

Coming back to Aramco valuation, we believe that the use EV/EBITDA (enterprise value versus core earnings), a simple and globally accepted ratio, should be of help to compare Aramco with some peers in the industry.

On an EV/EBITDA 2020e basis, **the 5 large Integrated Oil Companies (IOCs) trade at an average multiple of 5.6x**.

At an average Brent of Oil prices of $65 in 2020e, Aramco EBITDA for 2020e is expected to come out at $224 billion. Using the average multiple highlighted above, this would justify an Enterprise Value of $1.25 trillion. **However, given Aramco's superior profitability, we do believe that a much higher EV/EBITDA multiple is justified**. Applying a 50% premium would imply an 8.4x EV/EBITDA ratio and a 2020e enterprise value of roughly $1.9 trillion – and thus a **$1.8 trillion valuation** if we apply a 9% discount rate (3% risk-free + 6% equity risk premium).

Valuation ratios versus the 5 major IOCs are summarized in the table below:

	P/E		EV/EBITDA		EV/Reserves	ROAE	ROAIC	Dividend Yield
	2016	2017	2018	2019e	2020e	2021e	2022e	2023e
Exxon Mobil	0	(38)	(56)	(46)	(36)	(37)	(39)	(40)
Shell	(17)	(16)	(16)	(18)	(33)	(48)	(49)	(52)
Chevron	(3)	(4)	(2)	(2)	(3)	(3)	(3)	(3)
Total	(14)	(14)	(14)	(14)	(14)	(14)	(14)	(14)
BP	(9)	(10)	(11)	(13)	(16)	(19)	(21)	(22)
Average IOCs	91.4	163.7	221.2	181.4	222.1	238.1	249.2	260.3
Aramco*	(68)	(79)	(102)	(82)	(98)	(103)	(107)	(111)

** Based on $1.8 trillion valuation*

Valuing the stock as a high- income, low growth stock

As an alternative to the valuation methodologies discussed before, some might consider Aramco as a low-growth, income stock. Even though it is the most powerful member of OPEC, Saudi Arabia is restricted in being able to raise production, hence, earnings growth will thus have to come via oil and gas prices. If all the free cash flow goes to paying out a dividend that would imply a high payout but not an unrealistic one for a cash cow.

On a 5% required yield, similar to the largest oil groups, Aramco looks to be worth at least $1.5 trillion. With the dividend expected to grow steadily, the valuation would rise higher.

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On a 5% dividend yield, similar to the largest Oil groups, Aramco looks to be worth around $1.5 trillion

Geopolitical risk discount (or quality premium?)

Financials aside, investors will also assess country risk when working out Aramco's valuation. Saudi Arabia is a key player in international oil markets; historically it has assumed a key role in shaping OPEC policy and is the only country with an official policy to hold spare capacity. Changes in oil policy, which are sovereign decisions, can have a direct impact on the company's valuation through its impact on production levels and prices.

The recent drone missile attacks on Aramco assets could also lead the market to apply a valuation discount.

However, it is worth highlighting that the company can also be seen as a high quality / defensive large-cap story. Aramco has a net cash position (i.e. negative net debt) and many investors might be attracted by the guaranteed USD 75 bn in dividends. As such, the stock can be perceived as a semi-quasi sovereign bond and thus benefit from a quality valuation premium.

Aramco listing impact on EM and regional benchmarks

The potential impact of Aramco's listing on benchmarks is a theme which has been in focus for some time now. Back in 2018, the Shura Council's fiscal committee asked the CMA to "make sure that the stock market's liquidity does not become concentrated in the giant oil company alone" and "to study the impact of listing Saudi Aramco on the local bourse".

The size of the Aramco listing raises some key questions:

1 how will local and regional investors fund their participation in the Aramco IPO?;

2 what impact will it have on local and regional markets?; and
3 will we see a capped Tadawul index (Tadawul excl. Aramco)?

Based on an EFG Hermes report, Aramco is expected to be an Index heavyweight. For every $10 billion in free-float market capitalization, Aramco should account for roughly 4% of Tadawul index, 7% of the MSCI Saudi Arabia index, 3% of MENA benchmarks and 0.2% of MSCI/FTSE Emerging Markets Indices.

They estimate that every $10 billion of free-float market capitalization would drive around $1.2 billion (12% of free-float) of passive inflows from MSCI and FTSE trackers.

A fast track inclusion in the major benchmarks is also expected. Indeed, the FTSE has already waived the minimum 5% free-float percentage threshold for very large constituents, setting the stage for Aramco to be included quickly. As such, it is expected that Aramco will join FTSE benchmarks as of the close of the 5th day of trading and the MSCI benchmark as of the close of the 10th day of trading.

It is estimated that every USD10 billion in float market cap should lead to around 20 basis points additional weight in Emerging Markets (we expect 2.2% of MSCI EM at current prices for Saudi excl. Aramco), and around USD1.1 billion of inflows from MSCI and FTSE trackers.

Aramco could become the largest name in MENA by float market cap, the second-largest in EMEA and one of the Top 10 names in Emerging Markets. Assuming a USD24-25.5bn free-float, Aramco could account for around 10% of the Tadawul Index (which is equivalent to the largest names such as RJHI and SABIC). It would also mean that Aramco is roughly 10% of MSCI Arabian Markets and around 3.5% of the MSCI EMEA.

The IPO is expected to be a challenge for local and regional relative mandates as index performance, once it is included, would largely depend on Aramco's performance (and thus oil prices to a certain extent). It is highly likely that we will see an increase in the use of custom-local and regional benchmarks that would cap Aramco (within Saudi indices) and cap Saudi & Aramco exposure (within regional indices).

There is a silver ling though. As recently highlighted by Templeton, the listing of Saudi Arabia's state-owned oil company could kick-start the kingdom's long-awaited privatization program and thus reinvigorate the Saudi stock exchange IPO market.

A successful Aramco listing on the Saudi stock exchange (Tadawul) would provide a much-needed shot of confidence for local investors. It could also be the nudge required to bring even more Saudi companies to market. The Saudi authorities have an ambitious target of increasing the number of listed companies on the Tadawul from 193 to 250 by 2022.

The Saudi government has said it wants to raise as much as US$200 billion through privatizations in the coming years. This includes the kingdom's target of generating US$9 billion-$11 billion from the privatization of assets by 2020, spanning sectors including health, water, transportation, education, municipalities, energy, sports and communication.

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Historical precedents

The only IPO in the oil & gas industry that possibly generated a similar buzz and bore reasonable similarities was that of Petrobras' in 2010. Brazil's state-owned oil producer raised US$70 billion by selling 36 percent of the government's stake. Brazil's oil sector, back then, contributed nearly 10 per cent of the country's GDP.

Brazil's government received $43 billion in shares in exchange for allowing Petrobras to drill for 5 billion barrels in reserves. The offer was also part of Petrobras' development targets in 2010, with capital worth $224 billion needed over five years for oil extraction from the "pre-salt layer" under approximately 4,000m of salt which was further 2,500m below the Atlantic Ocean.

However, five years after ambitious production targets and raising a significant amount of money, the company's performances fell a bit short of expectations. Not to mention, the political and corporate irregularities that started to surface. Reports of funds from construction companies being diverted for political purposes and large amounts of unaccounted expenses also impacted investor confidence.

We take away the following from the Petrobras example:

- **A big government stake meant there was always a mix of politics and business which impacted performance and ultimately Petrobras' market valuation.**
- **Given the size of the IPO and a subsequent weak performance meant the Brazilian Stock Exchange bore the brunt of it. At one point, Petrobras accounted for nearly 10% of the country's total market capitalization. A sell-off in a counter as big as this can easily trigger a 'risk-off' trade and exacerbate the impact.**

10 Key Investment Themes

Below, we highlight the 10 key investment themes of the Saudi Aramco IPO.

1 Aramco is the largest and lowest-cost producer globally

As highlighted earlier, Aramco is a colossus, being the largest oil producer in the world, with over 10mbbl/d of crude and 13.6mmbbl/d of hydrocarbons. It also has a much higher profitability than peers as its scale and the unique geology of Aramco's fields enable the company to benefit from the lowest lifting and capex costs per barrel in the world (c72% lower than Integrated oil companies average).

2 A superior return profile

Aramco has much higher returns than peers, with an average ROAE (return on adjusted equity) in 2018 of 46% versus peer average of 10%. With oil prices staying at current level, we expect $200bn+ EBITDA in 2020e.

3 Unmatched Reserve replacement cost

Saudi Aramco controls more than one-fifth of global petroleum reserves. Each oil barrel is replaced at a cost of sub $3/bbl vs $15/bbl for other Integrated Oil Companies.

4

A defensive stock

Aramco has a pristine balance sheet (it is net cash positive) and guaranteed a $75 billion dividend (see below) which is expected to grow thanks to its strong free cash flow outlook. We also note that the company structure is defensive thanks to a three-tiered royalty structure that remains low (15%) at oil price below $70/bbl. A Receivable offset mechanism provides further margin of safety.

5

Upstream liquid exposure

Aramco has the largest exposure to Upstream, as well as liquids versus peers, which we consider as a positive, as oil returns have historically been better than gas and downstream.

6

Downstream to drive growth

Aramco has expanded its downstream business substantially in the past decade, with the company's business portfolio essentially covering the entire value chain. We believe that Aramco has leveraged its downstream portfolio successfully in order to capture further value and margin along the chain, drive growth beyond the upstream business and diversify products, generate demand for its upstream oil and gas business, expand its customer base but also balance demand and supply within the local Saudi market.

7

A quasi-guaranteed dividend

Aramco has promised minor investors a prorated share of at least $75 billion in dividends for the coming 5 years, guaranteeing a yield for investors. The ability to pay a high dividend yield is key to attract investors in the region but also global investors which are eager to invest into high yielding assets.

8

Untapped exploration potential

With the exception of the Eastern province, Saudi Arabia has seen relatively low levels of exploration across its other regions. There could thus be significant upside from other areas in KSA as the majority of the land remains unexplored.

9

Below peers CO_2 emissions

Aramco's CO_2 emissions in 2018 were amongst the lowest in the world per barrel produced.

10

A fast track to MSCI and FTSE indexes inclusion

Aramco is expected to be an Index heavyweight. For every $10 billion in free-float market capitalization, Aramco should account for roughly 4% of Tadawul index, 7% of the MSCI Saudi Arabia index, 3% of MENA benchmarks and 0.2% of MSCI/FTSE Emerging Markets Indices. It is estimated that every $10 billion of free float would drive around $1.2 billion (12% of free float) of passive inflows.

5 Risks to be considered

1

Oil prices

Positive investment case is built on oil prices at around $65/barrel; any increase or decrease from this level would pose a (downside/upside) risk to the stock price.

2

Production growth risks

Positive investment case assumes an annual crude production increases for the coming years which in line with growth witnessed in the past decade. However, Aramco's crude production is determined by the government and is subject to market factors. There are thus upside and downside risks to this assumption.

3

Concession risk

While the concession agreement cannot be amended, modified, waived, discharged or terminated without written consent from both the Company and Ministry of Energy, there is one (very unlikely) exception which is a change of the law by the government (and this can be enacted unilaterally by the government).

4

Concentration / country risks

With 100% of the company's upstream assets located in the Kingdom, there are concentration and country risks for the name.

5

Geopolitical / security risk

Regional tension is considered as one key risk for the company.

Conclusion

We have been firm believers of the Saudi transformation thesis for some time now. While many investors were skeptical about the ability of Saudi Arabia to roll out its ambitious agenda, they seem to be right on track: Saudi index inclusion, economic, societal and structural reforms and now the Saudi IPO are all happening and vindicate our view that there is strong willingness by Saudi leadership to transform the Kingdom.

As discussed earlier, we believe Saudi Aramco's IPO is a central pillar of Saudi Arabia's 2030 Vision. In our view, the broader privatization of state assets will likely accelerate the flow of foreign capital into Saudi Arabia, improve liquidity and transparency as well as continue to help diversify its economy away from its dependency on oil.

Aramco IPO is expected to be the largest IPO ever. As highlighted in this report, Saudi Aramco stands out from the other Integrated Oil companies given the size of its reserves, superior profitability level, its lowest cost to produce and replace barrels, its defensive attributes and massive unexplored potential.

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Our investment thesis is positive on the stock as a $1.5 to $1.8 trillion market valuation can be justified on various valuation metrics (this is NOT an investment recommendation).

IPO details and timing are highlighted below.

INSTITUTIONAL TRANCHES	RETAIL TRANCHES
This tranche will not require prefunding – basically after the allocation is made the investors are requested to make the transfers.	Will require prefunding and most banks are providing leverage
	Allocation will be pro-rata
Allocation would be 100% on discretion. The final say on this is Aramco management but of course, the advisers will play a role.	Retail investors who keep the shares for 6 months after the listing will get 1 free share per 10 shares, with a cap of 100 free shares

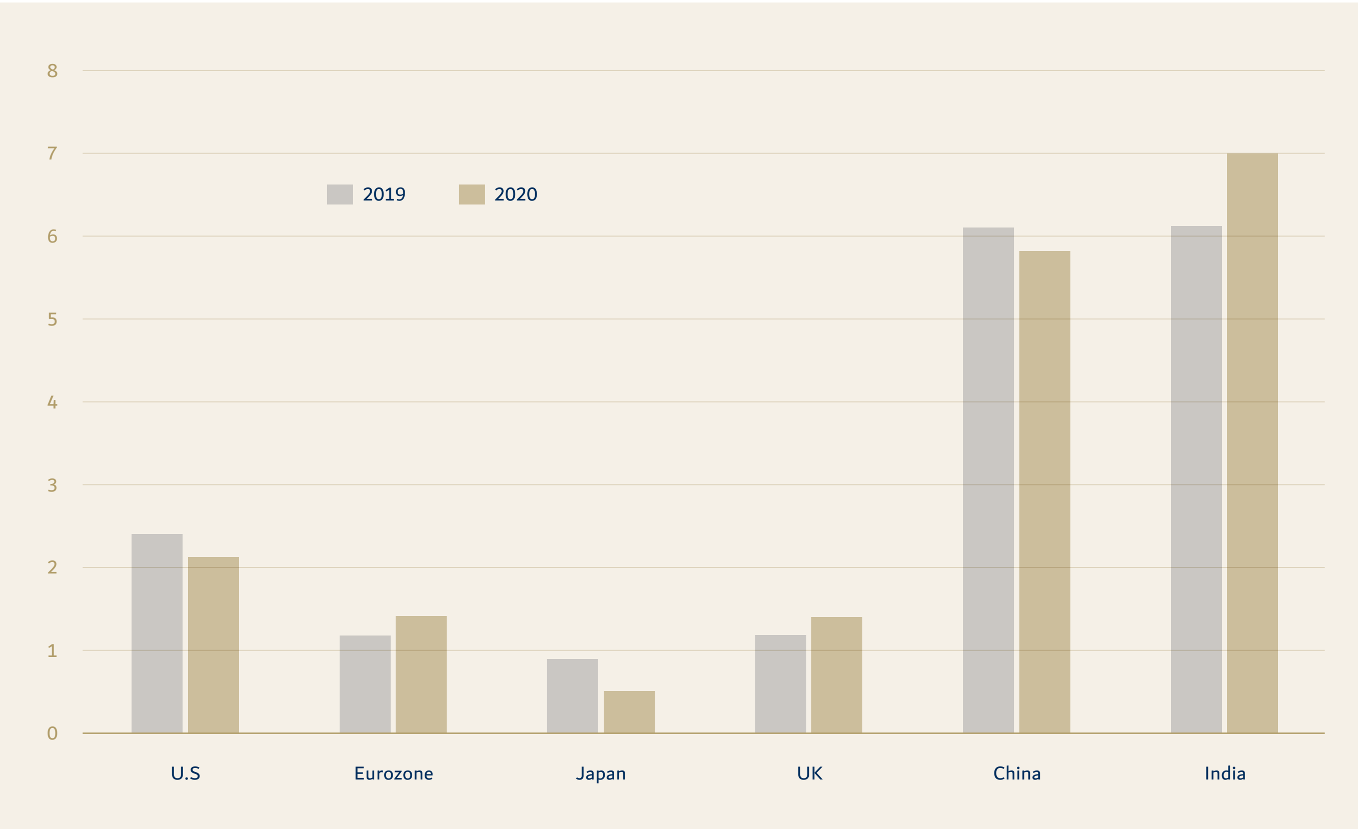
Size is expected to be 1.5% of the company shares. The price range of the offering is SAR 30-32, which is equivalent to a valuation range of US$1.6-$1.7 trillion and thus a deal size between US$24bn to US$25.5bn. This would imply a dividend yield between 4.4% and 4.7%.

TIMELINE	
9th Nov	▶ Prospectus for local investors was issued
17th Nov	▶ Prospectus for International investors was issued
17th Nov	▶ Pricing range was announced
17th Nov to 2nd Dec	▶ Management roadshow
18th Nov	▶ Start to accept orders
26th Nov	▶ Last day for retail offering
4th Dec	▶ Last day of the institutional offering
5th Dec	▶ Share price announcement
11th Dec	▶ Listing on Tadawul

Global Backdrop Should be Supportive of MENA's Investment Climate in 2020

With the start of 2020 rapidly approaching, some of the key global macro and financial market trends that play a role in shaping our regional investment climate are beginning to come into focus. Emerging markets differ in the extent to which they are exposed to these external factors (depending on their level of openness, trading relationships, depth of financial markets etc.), however, there is no economy which is completely insulated from global trends, and the Middle East and North Africa is no exception. Forming a view on a region, country, sector or company in MENA thus requires starting with a view as to how the broader global environment could shape the local business environment.

Real GDP Growth, % year-over-year

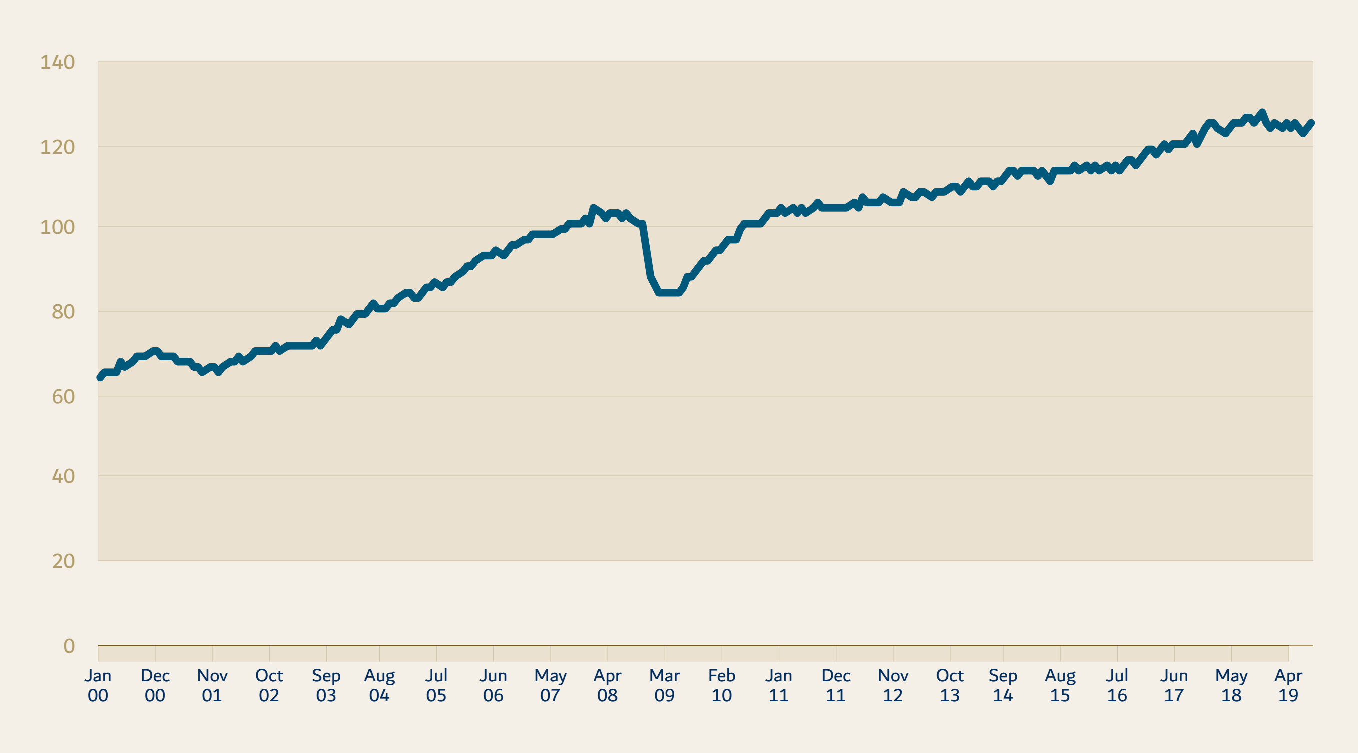


In its annual World Economic Outlook update in October, the IMF lowered its forecasts for global GDP growth in 2019 and 2020 to 3.0% and 3.4% respectively, describing the emergence of a "synchronized slowdown". The Fund's estimate for 2019 growth would represent the slowest pace of expansion since the global financial crisis. In justifying its views, the IMF cited a list of reasons behind the weakness in economic activity, including structural problems (low productivity and aging workforces), idiosyncratic country-specific factors, uncertainty surrounding trade and geopolitics, and the consequence of rising trade barriers.

Is the Global Pessimism Overdone?

Seen in context however, the only 'new' factor weighing on the global economy in 2019 and 2020 would appear to be the trade war. Indeed, aging workforces and geopolitical risks have been present for many years (the former is also very much a structural issue and generally is not factored into forecasts for the short-term business cycle). If this is indeed the case, in that the trade war is THE issue that is undermining the global economic outlook, some encouragement can be taken from the fact that in early November, there were indications that the U.S. and China were close to agreeing to a temporary deal. A resolution to the trade war, which can occur at a moment's (or Tweet's) notice, would mean that most forecasts for global growth next year could have significant upside potential.

World Trade Index



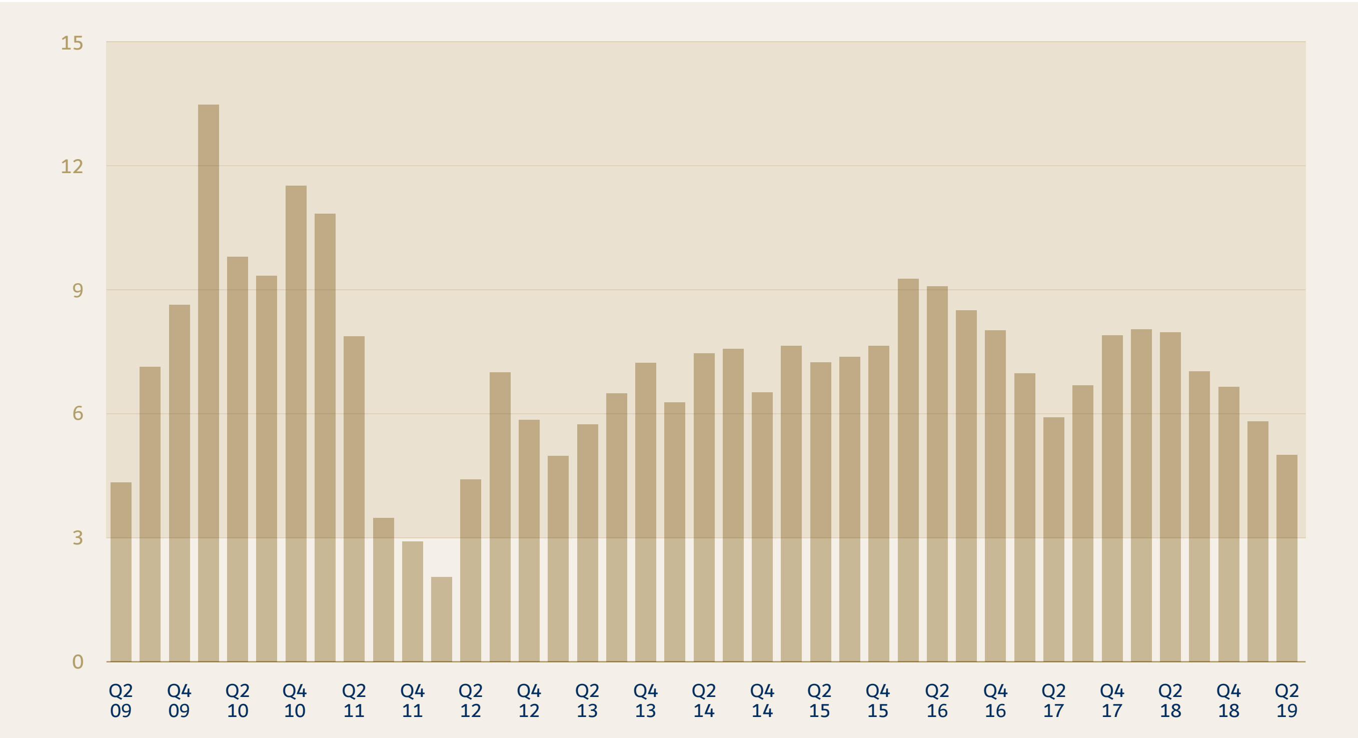
For MENA, this backdrop of lower but stable global growth and trade patterns should result in a relatively consistent outlook for the region's non-oil tradeable sectors. This includes everything from traffic through Egypt's Suez Canal (which has recently been increasing), to airline passenger traffic in key aviation transport hubs in Dubai, Doha and Istanbul, as well as throughput at seaports around the world (important for firms such as DP World).

October saw the GBP post its strongest gains in a decade as such risks were gradually priced-out of financial markets. This bodes particularly well for outbound British tourism, as well as investment flows into sectors such as Dubai residential real estate.

Some Trade Partners Matter More than Others...

There are several key economies around the world that could play a particularly influential role in shaping the outlook for the MENA region next year. For example, the UK is an important trade partner for the GCC and source of tourists for North African economies, and it is encouraging that most signs currently point to a low probability of a 'Hard Brexit' scenario. Indeed, October saw the GBP post its strongest gains in a decade as such risks were gradually priced-out of financial markets. This bodes particularly well for outbound British tourism, as well as investment flows into sectors such as Dubai residential real estate.

India Real GDP Growth, % year-over-year



China is another key market, where growth is undeniably slowing (6.0% y/y in Q319, representing the weakest pace in 30 years), although the near-term outlook is also partly dependent on the outcome of trade talks. As ties between China and the UAE have only recently gained momentum (i.e. they are starting from a low base), in our view there is still scope for stronger trade and investment integration in 2020, even under a scenario of weaker growth in the Chinese market. Of more concern perhaps is the outlook for the Indian economy in the near term, where GDP growth has settled onto a slightly lower trajectory, and could potentially reduce trade and tourism demand in markets such as the UAE. That said, while near-term momentum has faded, forecasts for 2020 are relatively bullish, with the IMF, for example, projecting Indian real GDP to bounce back to 7.0% next year.

GCC Monetary Policy is Now Appropriate to Economic Backdrop...

Even as the American economy has been a relative bright spot in the global context, the U.S. Federal Reserve carried out its third interest cut in four months in October, bringing the Fed's target range down to 1.50-1.75%. It can be argued that this monetary loosening was unnecessary given the ongoing strength of the U.S. consumer, which accounts for roughly 70% of GDP. Indeed, three interest rate cuts in an economy with unemployment trending at 50-year lows (3.6% in October) might eventually prove to have been overly cautious. At the time of publication, financial markets were also pricing-in the probability of another interest rate cut in H1 2020.

Nevertheless, for our region, as GCC central banks largely follow the lead of the Fed (albeit with a few exceptions), these U.S. rate cuts have translated into much needed monetary loosening, and could, at the margin, help spur an improvement in private sector credit growth. With the exception of Qatar, private sector loan growth in much of the region is trending in the low single-digits. At the very least, it is evident that the monetary policy stance which now exists in the GCC is certainly more appropriate to the current strength of the regional non-oil economy.

USD Dollar Index

The easing in U.S. interest rates has coincided with a period of ongoing USD strength, with the Dollar Index continuing to trend near multi-year highs. Indeed, as concerns have grown surrounding the global economic outlook, central banks in both emerging and developed markets have responded by reducing interest rates in an attempt to prop up growth. Although no central bank publicly discloses a policy of deliberately attempting to weaken its exchange rate, the result of this global monetary loosening has been undeniable. This has, in fact, been a key reason behind President Trump's criticism that the U.S. Federal Reserve has not cut interest rates sufficiently, particularly given the European Central Bank's recent push deeper into 'negative rate territory'. Looking ahead, the implication for 2020 is that for many MENA economies that maintain fixed USD exchange rates, dollar strength is likely to remain a fairly consistent theme.

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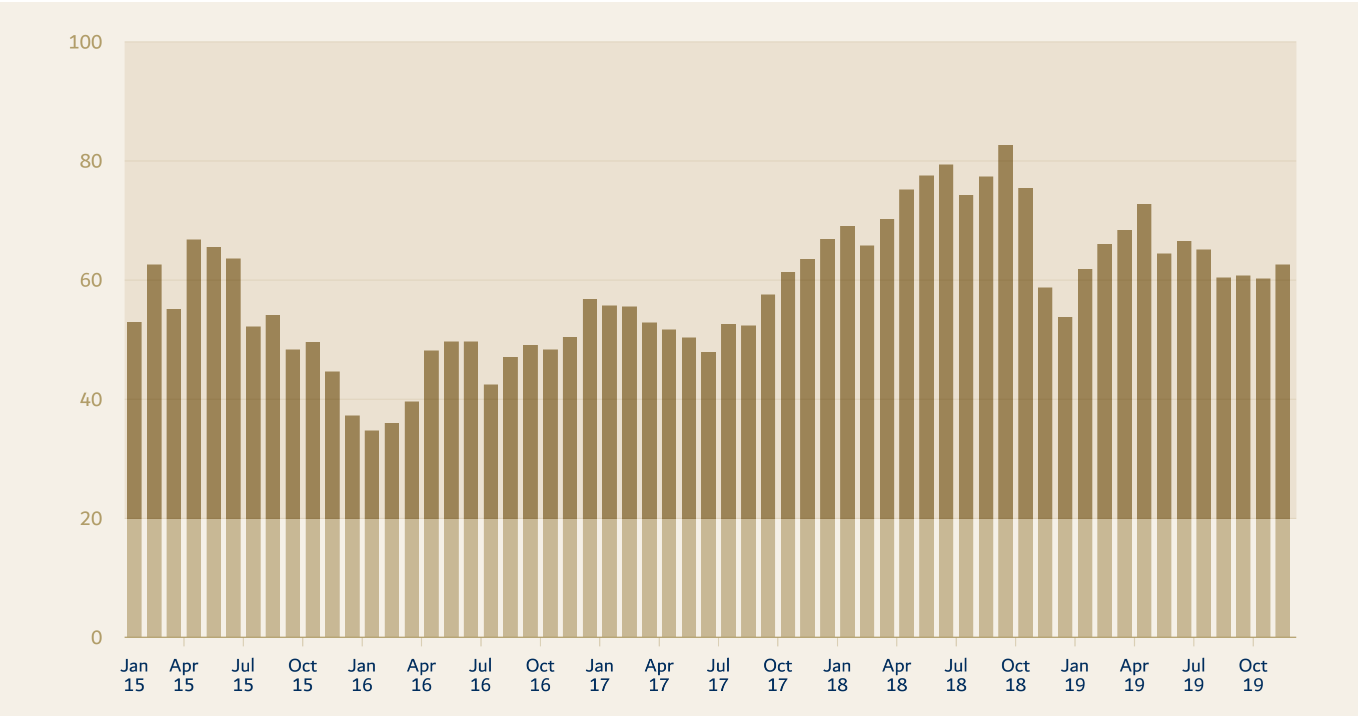
Oil Markets Defined by Remarkable Stability...

For global energy markets, 2019 has been defined by a remarkable degree of stability in oil prices. Although prices jumped sharply following the September attacks on Aramco's facilities, they soon settled back into the USD60/bbl range where they had been trading for several months. OPEC's ongoing production-cut agreement so far appears to have been balanced by growth in non-OPEC supply, as well as lower forecasts for 2020 global demand growth (the strength in the USD also limits upside potential). With OPEC's current agreement set to expire in March 2020, there are reports the organization is beginning to consider making even deeper cuts, which suggest to us that the cartel is not satisfied with the current level of prices.

Brent Crude Oil, Avg. Monthly Price, USD/bbl



From our perspective however, oil in the USD60-70/bbl range can bring benefits to the regional investment climate. For the GCC's largest economies, fiscal balances will either be close to balance or in the single-digits, implying there is little risk of another round of large cuts to government spending (which played a major role in weakening the regional non-oil economy since 2016), or a threat of large-scale withdrawals of government deposits from the banking sector. At the same time, without an extended period of large fiscal surpluses, we also suspect that the incentive to continue pushing ahead with reform momentum will remain strong in 2020. This is a critical point to keep in mind when considering the regional outlook, as while reform momentum has been unprecedented in recent years (Saudi Arabia was one of the strongest reformers in the World Bank's latest Ease of Doing Business survey), there are still many areas that can be liberalized or reformed to help raise non-oil growth potential. Certainly, for MENA's oil-importing economies, energy prices at current levels do not pose a drastic risk to their current account deficits or ability to undertake further monetary easing.

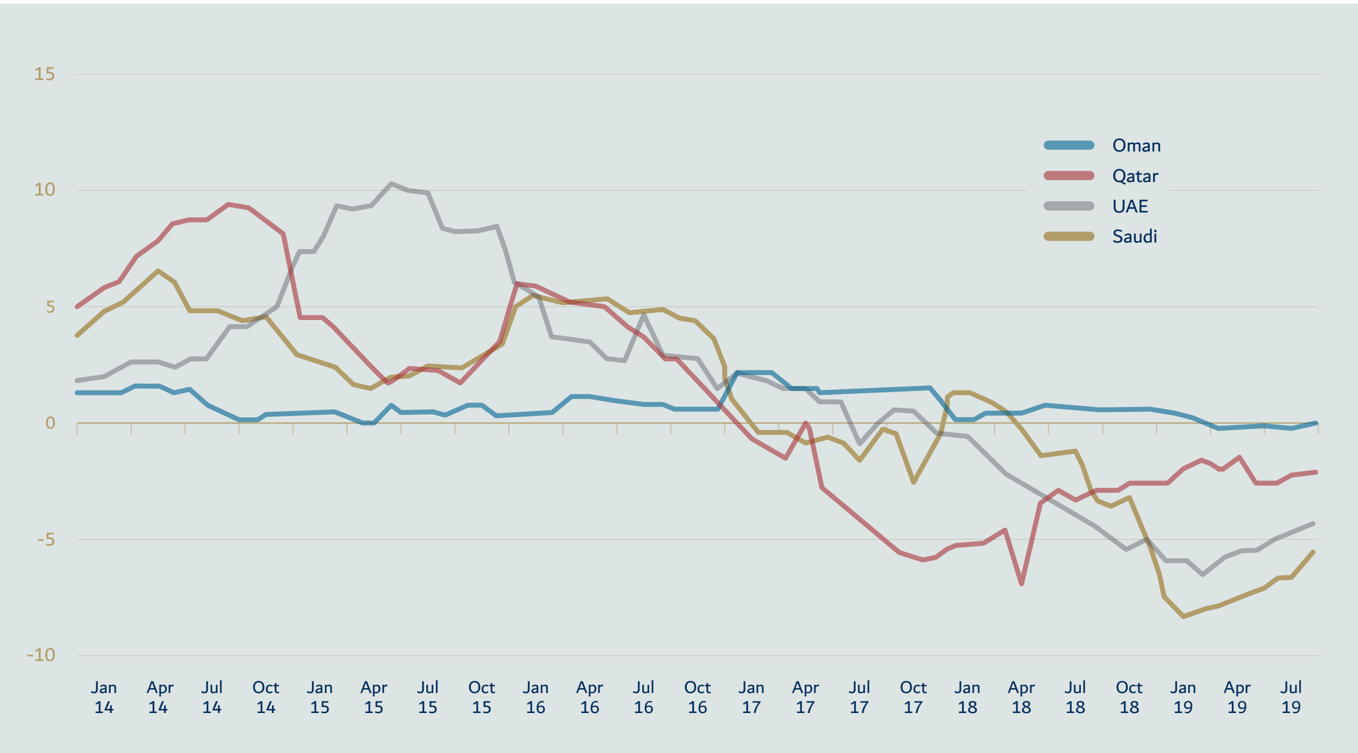
From our perspective however, oil in the USD60-70/bbl range can bring benefits to the regional investment climate.

GCC Real Estate Market Comes into Even Greater Focus

The real estate market has historically absorbed a significant share of discussion surrounding the investment climate in the GCC, however recent weeks have seen an even larger degree of focus on the industry than normal. From the creation of new committees charged with overseeing the sector, to proposals for new bank lending regulations to the industry, requests for a halt to supply, as well as public disputes amongst high-profile developers (quite rare in this region), it is clear that calls for reform are growing louder. How these questions are resolved over the coming months could have significant repercussions for homeowners, developers, and financial institutions in the years ahead.

When looking at the outlook for the property sector, it is often striking the extent to which most analysis focuses exclusively on micro-trends in a particular city, such as short-term supply growth or even the characteristics of particular neighborhood developments. Taking a moment to broaden our horizon to the regional outlook makes clear that the residential real estate sector across the entire GCC is exhibiting very similar trends, which suggests that larger macro factors must have played a role in driving these apparent micro-trends. This is most evident in trends in housing price inflation, or as the case has been in 2019, housing price deflation. The majority of the GCC is currently seeing lower housing costs, pointing to a region-wide downturn. Latest inflation data shows housing costs in September declining -5.6% y/y, -4.3%, -2.1%, and -0.2% in Saudi Arabia, the UAE, Qatar and Oman respectively.

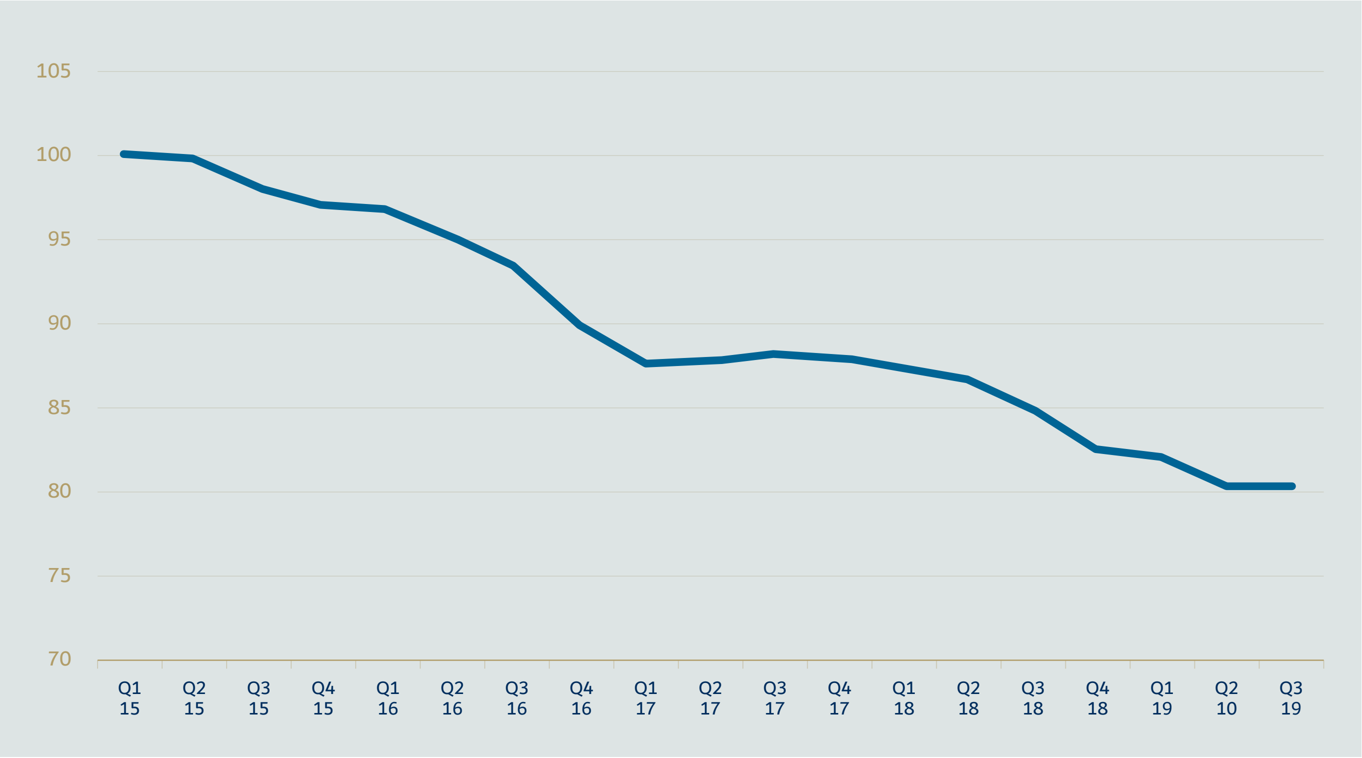
Consumer Price Inflation, % year-over-year



Weakness in the regional property market is likely symptomatic of several important factors. On the demand side, there has undoubtedly been a slowdown in non-oil economic growth and job creation in recent years, which has stifled population growth. In some markets such as Oman and Saudi Arabia, workforce nationalization policies (and uncertainty over future job prospects) also appears to have played a role by decreasing the willingness of expatriates to invest in housing.

Of course, the cost of capital has also been a slight headwind in recent years, as GCC central banks were forced to tightening monetary policy alongside the U.S. Fed. That said, with 2018's interest rate hikes now having largely been reversed, the lower (and more appropriate) interest rate environment that prevails in the region today should help support mortgage demand as we head into 2020. The impact will clearly be felt to a greater extent in markets where transactions depend more on mortgages rather than cash payments. Interestingly, the Q319 report from the Dubai Land Department showed the value of mortgages accounting for only 27% of the total value of transactions for Units (rather than Buildings and Land) in that quarter.

Saudi Arabia Real GDP Growth by Sector, % year-over-year



Calls for Greater Oversight of UAE Property Market...

Five years into the property downturn in the UAE, calls are now becoming louder for specific policy measures that could help 'rebalance' the market. Prices in Dubai are currently -25% below their peak hit in October 2014 according to data from the Bank for International Settlements. Perhaps more so than in other regional economies, the extent of decline in Dubai's residential real estate sector is a function of supply growth, with approximately 50k units set to enter the market in both 2019 and 2020.

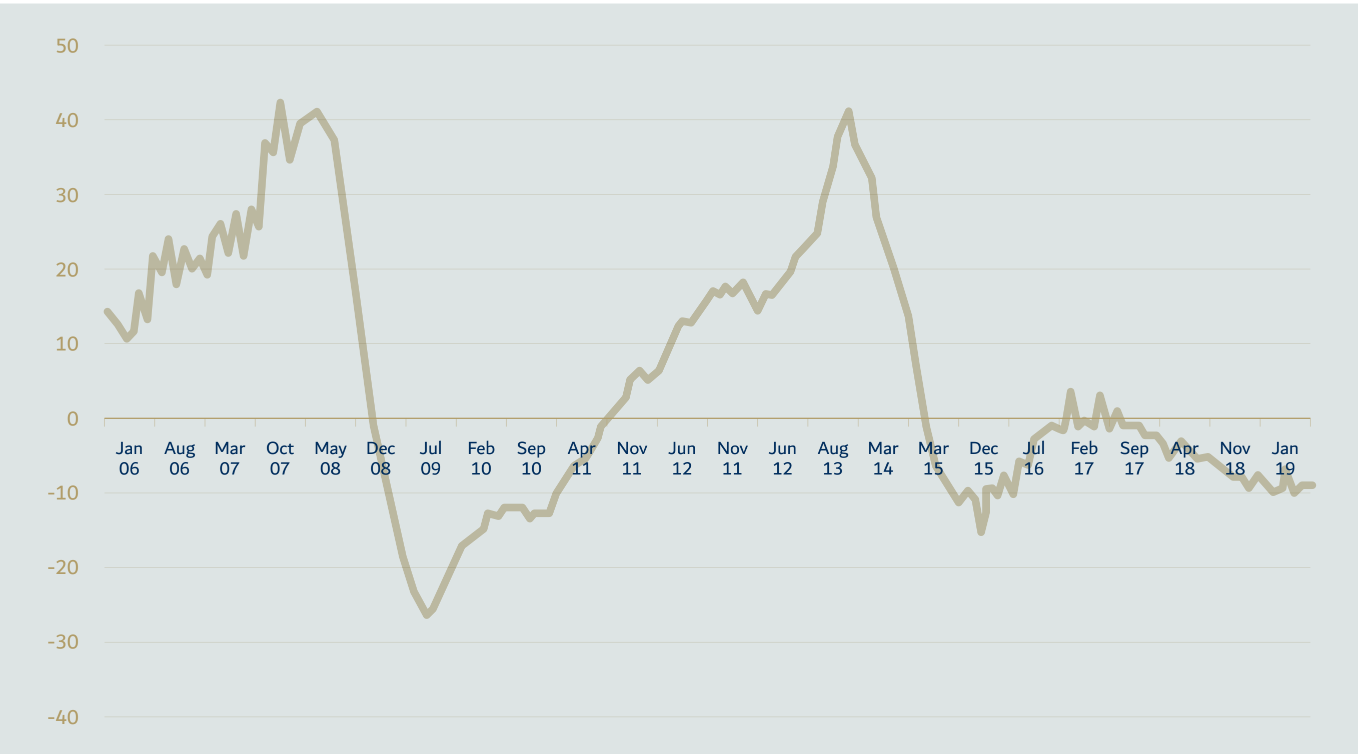
Given the length of this current market downturn, calls for reform are gradually increasing (from developers, not the rental community). In September it was announced that Dubai would set up a committee charged with overseeing the property market, and which is tasked with drawing up a 10-year strategic plan for the sector. More recently, the Central Bank of the UAE has sent proposals to the domestic banking sector that would help reduce their exposure and vulnerability to a market downturn.

It is important to keep in mind that while prices are falling, the real estate sector itself has been a key driver of economic growth in the emirate in recent years (it is this strong growth which has now led to the market correction). Indeed, the real estate industry was the largest contributor to GDP growth in Dubai in 2018, having expanded 7.0% y/y in real terms, while over half of the new private sector jobs that have been added over the past two years have been from this one industry. Without the stimulus provided to the economy from real estate, the overall macro performance would have been considerably weaker.

Falling Prices Can Bring Benefits...

In some cases, the unique socio-economic backdrop of the GCC raises some interesting questions about the actual relationship between the real estate sector, the average household, and the wider economy. For example, in the UAE we suspect that overall levels of homeownership are relatively low compared to global averages (we define 'low' as ownership levels below 50%) due to the fact that 90% of the workforce is composed of expatriate workers, who under most assumptions, would be more likely to rent their properties. In this context, falling residential real estate prices could be to their benefit, bringing as it will a large boost to their real spending power.

Dubai, All Dwellings, per sqm, % year-over-year

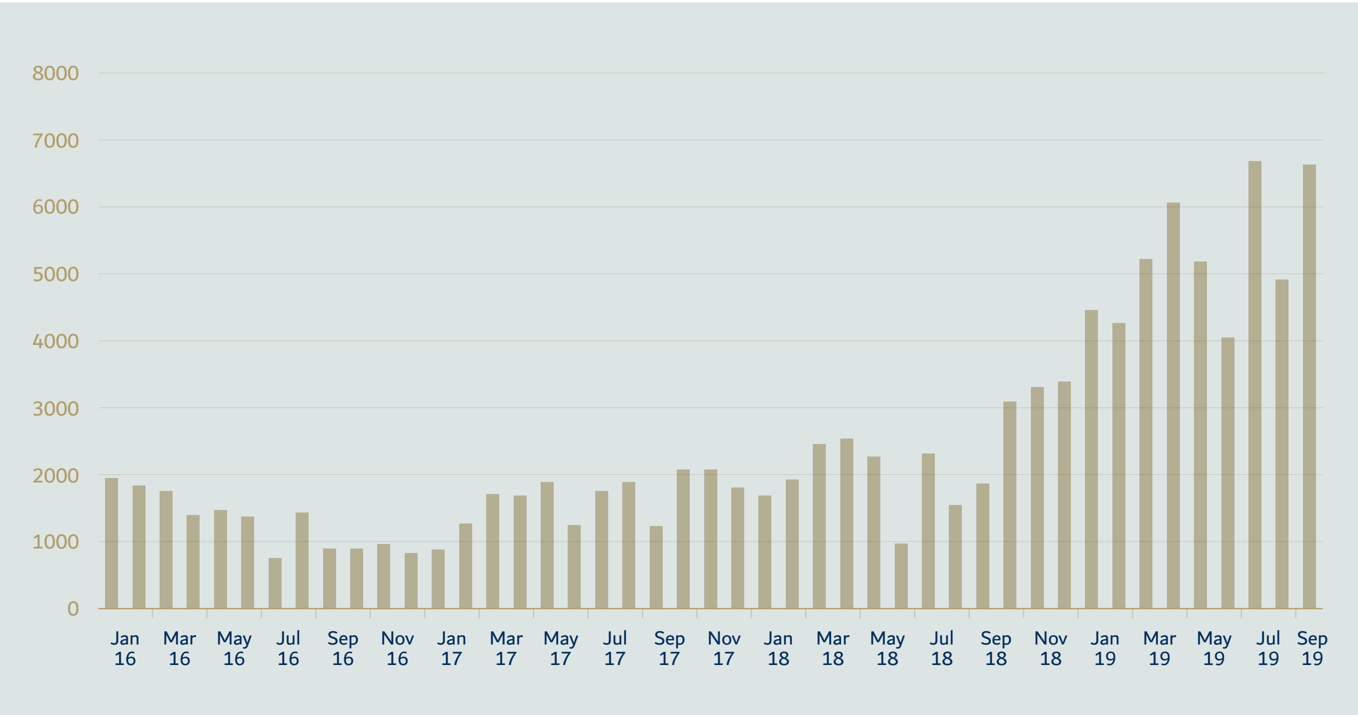


While it has been argued that many home renters have not benefitted from a large decline in their annual rent payments due to their decision to upgrade to larger properties, relocate to other more expensive emirates to be closer to their jobs, or simply due to the stress that accompanies a move, we would argue that these are not arguments that negate the positive impact of falling property prices on the consumer. Such trends might not be evident in the data, but these are all factors that go a long way towards improving the overall quality of life for many workers (which doesn't get captured in economic data). For an economy that must continue to attract foreign labor and international businesses over the long term in order to remain competitive, possessing an affordable housing market should be seen as improving the country's investment profile.

Housing Market Priorities in Saudi Arabia...

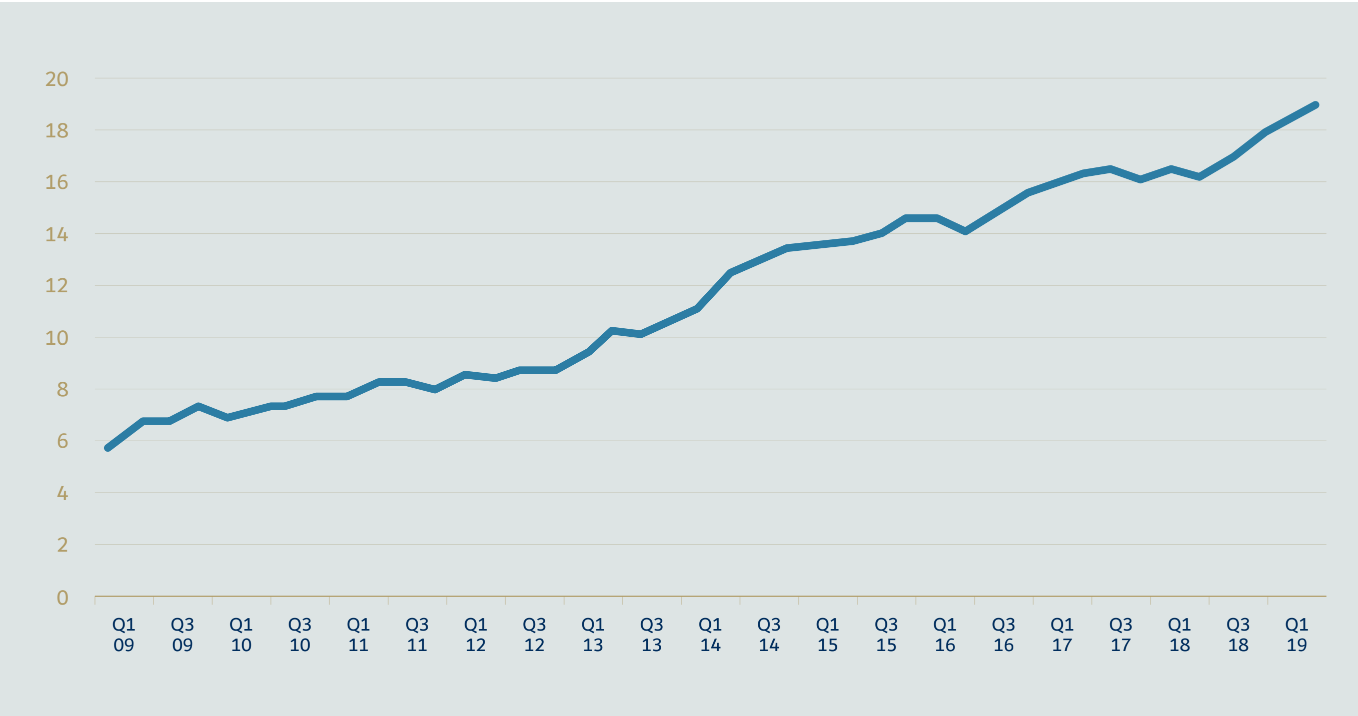
In contrast to the UAE, where real estate trends are being driven primarily by the fundamental free market forces of demand and supply, in Saudi Arabia the government has explicitly focused on the housing sector as one of the key initiatives of its long-term Vision 2030 development program. This government intervention into the real estate sector is underpinned by a prioritization on boosting overall levels of homeownership up to 70% by 2030, from 50% when the program was initiated. In Q2 the real estate sector expanded 2.4% y/y in real terms, compared to 4.8% in Q1, which is roughly in line with growth in the wider non-oil economy.

Residential New Mortgages Finance for Individuals Provided by Banks, SARmn



In 2018 a SAR120bn housing initiative was announced which saw the creation of a loan guarantee program, support for home down payments, as well as several initiatives aimed at residential New Nng the overall level of real estate financing to SAR500bn, from SAR280bn in 2017. Other recent initiatives have included the imposition of a 'white land tax' in order to incentivize landowners to develop their plots into residential communities rather than allow the land to sit idle, as well as an increase in the maximum loan-to-value ratio for first time homeowners to 85% from 70%.

Saudi Arabia Real Estate Loans as a % of Total Credit



Out of all of Vision 2030's long-term targets and reform priorities, this is one area that is most likely to succeed. Indeed, the combination of government support to stimulate the availability of new mortgages, alongside the natural desire to own property, combined with the policy's political popularity, would appear to raise the probability of success. Progress is already very much evident in the data, with the value of mortgage finance provided by banks rising to SAR6.6bn in September, compared to SAR1.8bn one year prior. Real estate loans as a share of total credit have risen to roughly 19%, compared to 9% at the start of 2013. In this sense, perhaps the key long-term challenge for policymakers will be in balancing the increasing desire and availability of homeownership, without also causing a large property glut that could persist for several years.

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FINAL WORDS

As we move towards the end of the year, the key question for investors is whether the "goldilocks" conditions which took shape throughout 2019 will prevail in 2020. Indeed, risk assets are evolving within a very narrow path. The global economy needs to be strong enough to avoid sparking recessionary fears and weak enough to keep policymakers on hold. Any decline in U.S or global growth expectations could spur recession fears. But should the Federal Reserve and/or ECB disappoint market expectations in the coming months, this could create some market panic as well. Meanwhile, any geopolitical tensions such as trade war or oil price "melt-up" could further dent investors' sentiment. If history is any guide, the later stage of the economic cycle is very often characterized by higher macro-economic volatility – and thus higher market volatility.

Looking ahead, we continue to believe that the global context remains favorable to risk assets. To the surprise of many, the next couple of months could provide an improving backdrop for global stocks. We note that market sentiment is not overbought as many investors have missed this year rally. Some cash might thus be deployed into equities before the end of the year and/or early next year. Moreover, the fall of bond yields has made equities more attractive on a relative basis and might trigger a new wave of share buy-back.

Coming back to MENA, we view the latest regional developments as very encouraging. The most striking example is Saudi Arabia transformation, a story on which we have been firm believers for some time now. While many investors were skeptical about the ability of Saudi Arabia to roll out its ambitious agenda, they seem to be right on track: Saudi index inclusion, economic, societal and structural reforms and now the Saudi IPO are all happening and vindicate our view that there is strong willingness by Saudi leadership to transform the Kingdom. As discussed earlier, we believe Saudi Aramco's IPO is a central pillar of Saudi Arabia's 2030 Vision. In our view, the broader privatization of state assets will likely accelerate the flow of foreign capital into Saudi Arabia, improve liquidity and transparency as well as continue to help diversify its economy away from its dependency on oil.

While our forecast and views are subject to changes, our commitment to serve our clients is not.

We remain at your full disposal for any specific issues you like to discuss, so please do not hesitate to contact us.

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