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## Lending on the line

### Hold up in projects pipeline another hurdle facing banks

- ▶ **Potential project finance pipeline exceeding \$120 bn provides boon for banks, but rollout now skewed toward 2011 after timetable changes**
- ▶ **SAMA has replenished foreign assets back to levels of a year ago, buttressing expectations for a fiscal surplus**
- ▶ **Inflation picking up pace due to global food prices and domestic demand; We are revising our 2010 forecast up to 4.7% from 4.3%**
- ▶ **2009 current account surplus estimate revised to almost SR100 bn on higher exports. We are raising our 2010 forecast by 77%**
- ▶ **Fallout of European debt crisis in Saudi Arabia should be restrained, banks mainly shielded from Greek contagion but oil prices at risk**

Improvements in Saudi Arabia's economic outlook have been set into motion by sizeable government spending outlays, but bank lending has yet to take a consequential role in shoring up the recovery process. Well into the second quarter, commercial banks are still lagging behind in considerably enlarging their credit portfolios, even as business confidence improves, oil prices remain high and banks' liquidity positions continue to look very robust.

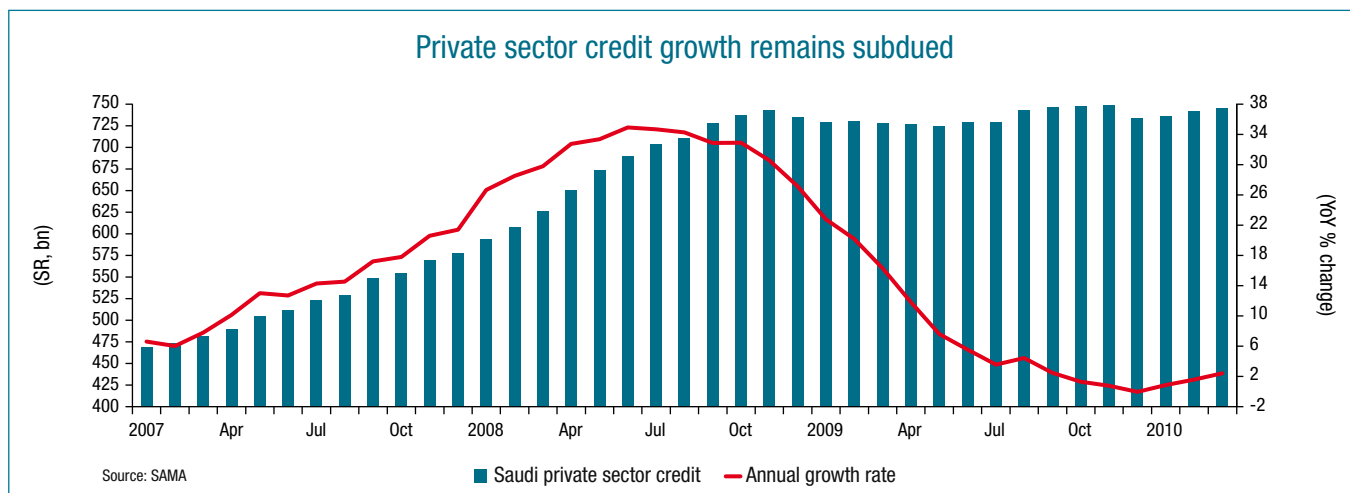
A factor hindering a bank credit recovery is the project finance pipeline which, although vast in size and scope, is unlikely to yield many large-scale lending prospects for banks until year-end and 2011, leaving little room for catalysts to energise loan growth in a meaningful way this year. The state, moreover, continues to shoulder the recovery by providing cost-advantageous loans to expedite key infrastructure projects in the short term, in some ways shunning higher borrowing costs of conventional financing to keep its strategy on course.

A scenario of some concern has emerged for banks, which are not being sufficiently roped in to taking part in such low-risk strategic lending opportunities. Hesitant about extending loans to smaller firms lacking established track records of credit worthiness, banks are also vetting with greater caution loan requests of longstanding family businesses as they rethink relationship lending policies after debt troubles surfaced among two such conglomerates in 2009.

The medium-term project financing outlook for banks remains robust despite ConocoPhillips pulling out of a giant Yanbu refinery project with Saudi Aramco this quarter just as the state oil giant and Dow Chemical revealed plans to overhaul a petrochemical project at Ras Tanura. Still, banks had expected to begin vying for a piece of the financing pie for these \$30-billion-plus projects as early as this quarter. Lenders still have plenty of projects to feed off of in 2010 while maintaining the 40% coverage ratio benchmark for import-exports banks. But with timetables for rollout of some key plays uncertain, trickle-down benefits for banks are likely to be held up for months to come.



May 2010



We expect Aramco to choose a new partner for the Yanbu refinery else fund it on its own. The state is doing the utmost to support a return to higher economic growth but a balance should be sought to ensure the private sector's investment role is adequately delineated.

It is plausible for bank lending to the private sector to expand by 8% in 2010 so long as a few large financing deals reach fruition this year. Some banks have started to lend more aggressively, including National Commercial Bank, Riyadh Bank and SABB, possibly compelling others to follow suit in order to retain market share. This month, a group including Riyadh, Samba Financial Group, and Arab National Bank expect to close SR14.5 billion syndicated loan for Saudi Binladin Group to fund construction of the King Abdullah Financial District.

As banks also build their retail loan books, this will bode positively on their performance in the coming months. Toward the end of the year and in 2011 - 2012, private sector credit growth potential will brighten further; according to our estimates, more than \$120 billion worth of projects will need to be financing through to 2012, with more than 60% of this taking place in 2011.

Snags facing bank credit revival aside, oil prices averaged \$80 a barrel in March and April and the kingdom is slowly raising output to cater to escalating global demand, ameliorating its fiscal position and enabling it to replenish its reserve of foreign assets back to levels of a year ago. A scenario of caution has emerged this month due to downward pressure on oil prices resulting from the European debt crisis. Still, a decline in bank deposits in the first part of 2010 and positive trade statistics also signal that businesses are again deploying money in the economy.

Financial deleveraging by European banks and the sovereign crisis in Greece and other eurozone economies, meanwhile, is in our view unlikely to have any serious and damaging spill-over effect on the Saudi economy. Inflation should gradually lose steam due to a recent slowdown in the pace of gains of global food and commodity prices, but we do not foresee a significant fall from current levels as a result of aggregate domestic demand.

## Outlook on the mend

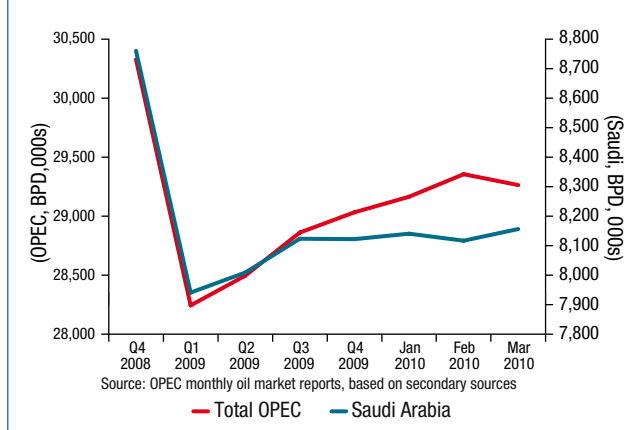
The economic environment is clearly much better than it was six months ago, especially after oil prices held above \$80 a barrel in March and April. With May's commodity sell off due to global contagion worries, crude prices promise to be volatile, but not necessarily fiscally concerning. Oil above \$60 a barrel buttresses Saudi Arabia's strong revenue position and encourages a healthy recuperation in foreign trade and personal consumption. Anything above \$70 a barrel, moreover, enables the kingdom to keep spending high while generating generous fiscal surpluses.

Saudi Arabia's medium-term prospects are cautiously optimistic given the outlook for oil demand and prices. OPEC member states have been incrementally raising output to meet growing demand despite the group keeping its output target unchanged since December 2008. Saudi crude oil production rose in March to 8.26 million barrels per day from 8.13 million barrels per day in February – 2.7% higher than the first quarter of last year. Still, a sustainable recovery in the United States and Asia is important for oil demand more broadly.

Saudi Arabia has acted as a balancer of global oil supply

May 2010

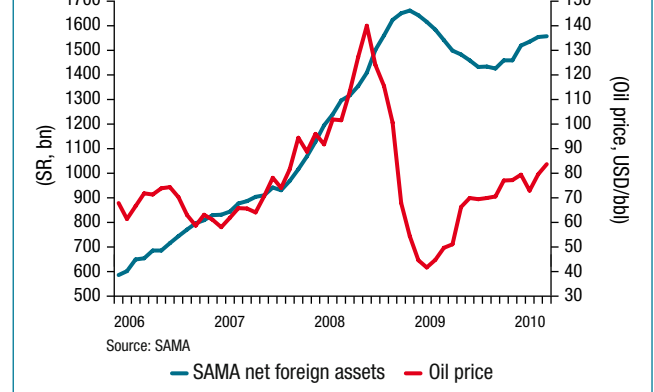
### Saudi oil production edges higher in March



because it maintains 1.5 - 2 million barrels per day of spare capacity, developed following investments of \$63 billion in the last five years. The kingdom plans to invest a further \$107 billion in the next four years in energy projects. The cost of drawing each barrel from onshore and offshore wells has risen substantially, the oil minister said last month. In 1998, extracting oil from the onshore Shaybah field cost \$5,000 per barrel of daily capacity. Eleven years later, it cost double that for the onshore Khurais field and triple that for the offshore Manifa field.

Higher output and oil prices have enabled the Saudi Arabian Monetary Agency (SAMA) to quickly replenish its foreign asset holdings. SAMA's net foreign assets in March amounted to SR1.56 trillion, bringing them back to the levels of a year ago. The central bank had drawn down foreign assets by 7.5%, or

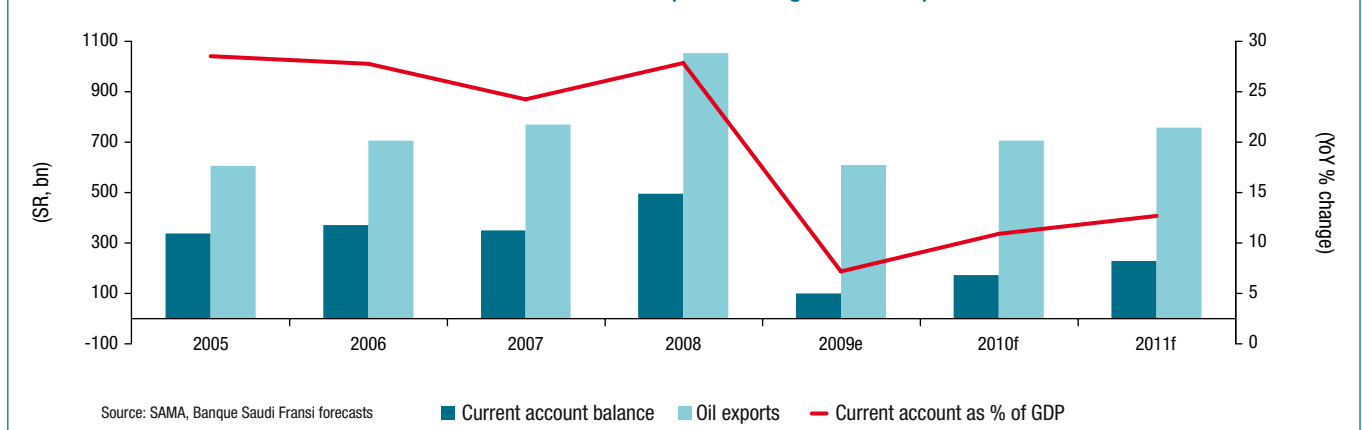
### SAMA replenishing foreign assets as oil prices gain momentum



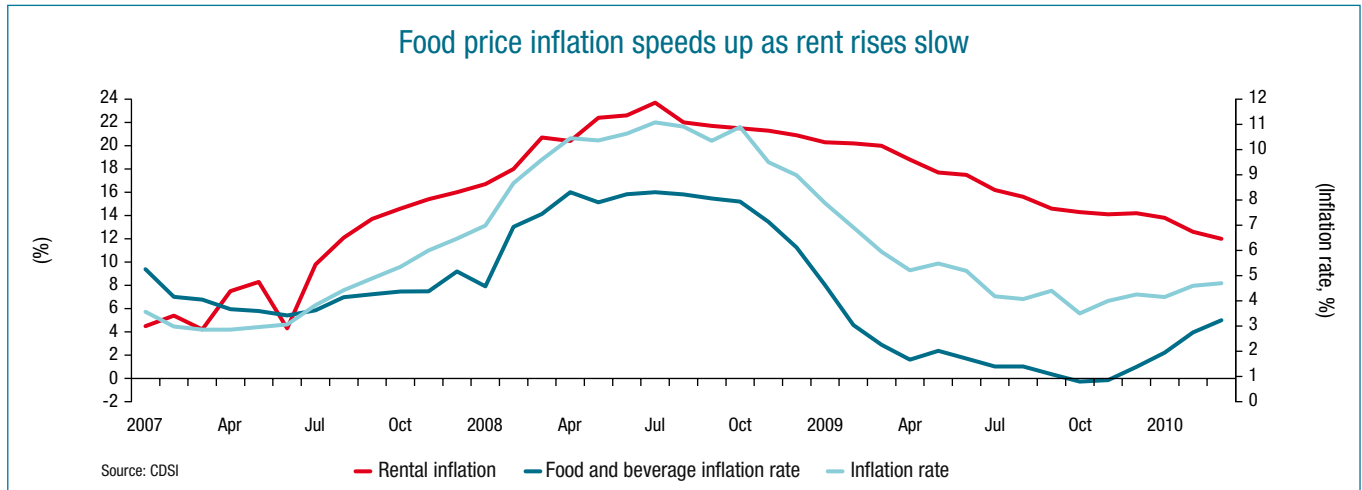
SR122.3 billion, in 2009, to help fund budgetary requirements during a period of depressed oil prices. At the height of the draw-down in September 2009, SAMA's net foreign assets were 14% off peak levels hit in November of 2008 – a year that saw oil prices swing as high as \$147 a barrel before plunging below \$40 a barrel in a matter of months.

Far less dependent on exports to Europe than countries in North Africa, Saudi Arabia could see its trade flows improve as the euro weakens further versus the dollar, although exports to the eurozone (accounting for 10.6% of the total) could get hit. European banks will continue to approach the Gulf with risk aversion, compounding the hesitancy to free up bank credit. On a micro level, as European bank valuations drop, this will create a negative wealth effect on Gulf sovereign wealth funds and investors at large. Saudi Arabia relies very

### Saudi current account surplus stronger than expected



May 2010



little on European leverage for financing various expansion projects and its banks have limited exposure to Europe. But deleveraging among global peers could prompt local banks could hold on abandoning risk aversion policies. Most Saudi banks, meanwhile, hold more U.S. paper than European paper. Bank for International Settlements data for the fourth quarter of 2009 show European banks have around \$174 billion of Gulf exposure, US banks \$34 billion and UK banks \$83 billion. Of this total cross-border banking exposure in the Gulf, half is with the UAE, 16% with Saudi Arabia and 17% Qatar.

Keeping volatile global conditions in mind, public investments remain strong albeit signs of gradual recuperation in private investment. The country awarded SR20.9 billion in development contracts in the first quarter – down almost 50% from the year earlier, although we expect this level to ramp up later this year.

Current account data also look more robust than previously expected. In revised numbers released by SAMA, the current account surplus was SR99.4 billion in 2009, up from a prior state estimate of SR76.7 billion. The gain resulted from stronger export revenues of SR711 billion, 3% more than earlier expected, including oil export revenues of SR609.7 billion – 6% higher than the prior estimate. In view of rising imports and higher oil output and prices, we are raising our 2010 current account surplus forecast to SR173 billion, or 10.9% of GDP.

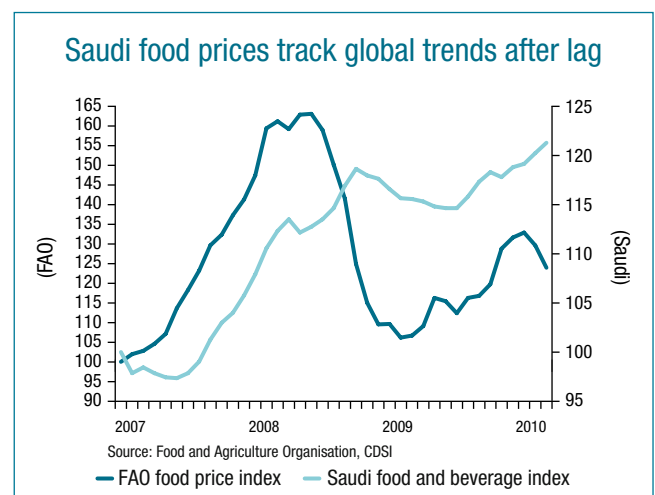
## Inflation picks up

Against this propitious fiscal backdrop, we have decided to revise our inflation forecast for 2010 upward to 4.7% from a previous expectation of 4.3% in view of the recent acceleration in global commodity prices, particularly of food, as well as

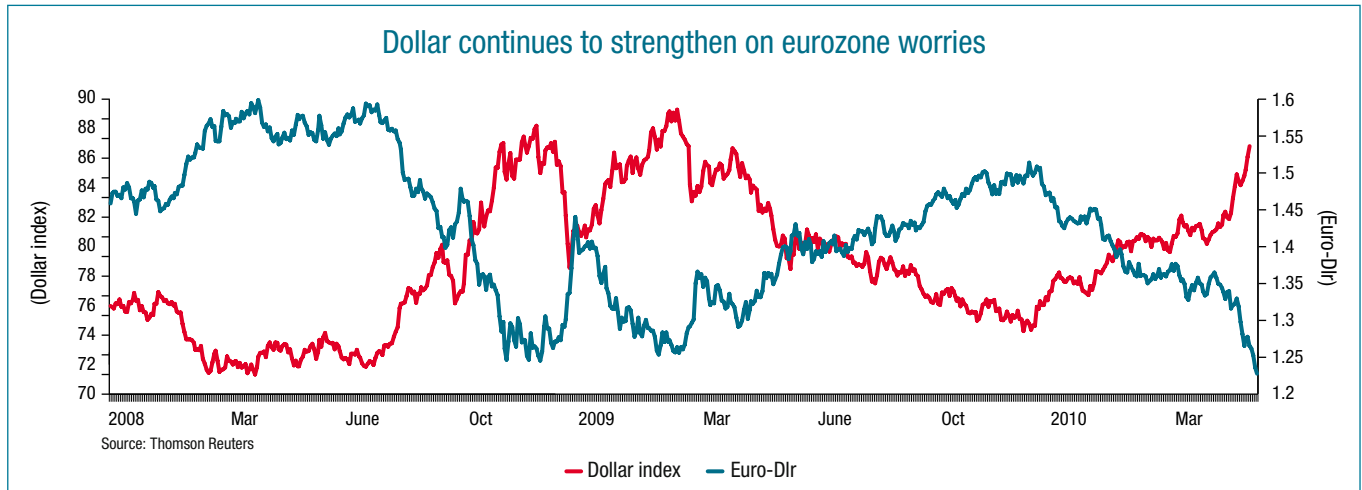
domestic factors including housing and a general rise in the cost of goods and services. Inflation in April rose to 4.9%, the highest since June 2009, and while we expect a deceleration in commodity and energy prices in the months to come, the price momentum is high enough to justify raising our headline forecast.

The Food and Agriculture Organisation's (FAO) food price index, which fell sharply in the first 10 months of 2009, has picked up pace this year, gaining more than 20% year on year in January and February. While food price inflation slowed to 16.1% in March, momentum in prices is still comparatively high versus 2009. The FAO index measures price changes in a food basket comprising cereals, oilseeds, dairy, meat and sugar.

The implications of firm global food prices for Saudi Arabia will be upward pressure on the consumer price index. Food



May 2010



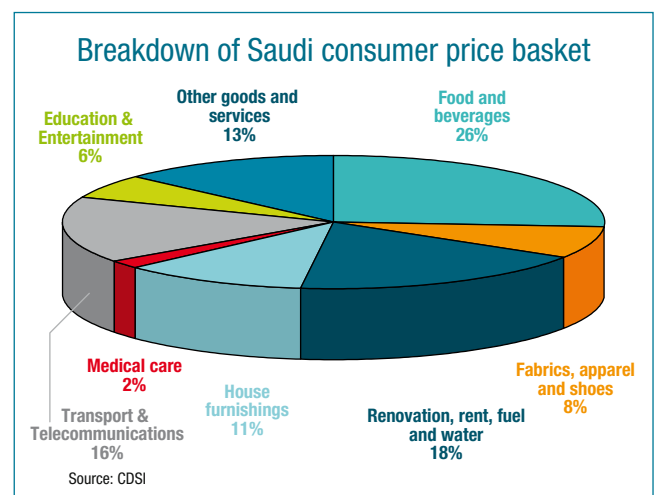
and beverage costs constitute the biggest weighting in the consumer basket at 26%, followed closely by the rent, fuel and water component at 18%. Saudi Arabia is heavily dependent on food imports. In 2008, imports of animal, vegetable, prepared food, beverages and tobacco amounted to SR62.2 billion, 14% of total imports, according to official data. Construction costs are also getting squeezed due to parallel construction progress on a series of megaprojects.

Other factors likely to contribute to Saudi inflation are home furnishings and other goods and services, a category including more than 400 items. These two categories comprise 24% of the index. Each of these components witnessed year-on-year price acceleration of 4% in March. However, import costs are moderated by the stronger dollar and largely benign inflation rates experienced by key trading partners. We expect the dollar to strengthen this year and that the euro will continue to weaken, although markets will eventually react to the reality that the U.S. deficit situation is not auspicious. U.S. inflation should average 2.2% in 2010 and 2.1% in 2011. Eurozone inflation is forecast to average below 1% this year and 1.4% in 2011, while price rises in China average below 3% in 2010 and 3.1% in 2011 and overall Asia inflation is seen at 3.3% and below 4% during the same period.

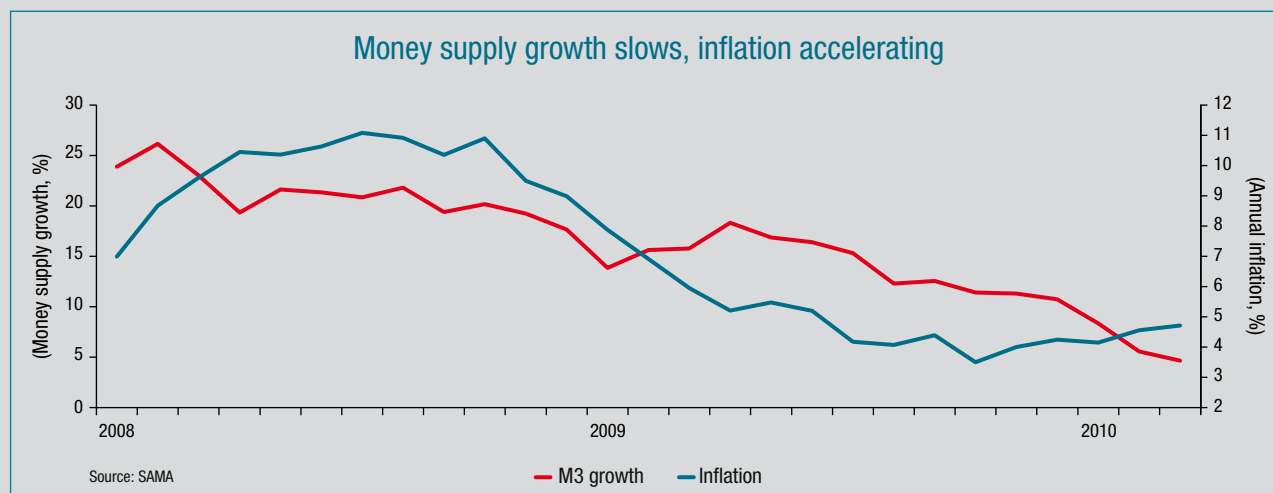
Slowing rental inflation is another factor likely to stabilise the headline rate this year. Rising rents were the biggest driver for high inflation in 2008, when the headline rate peaked above 11% in July. A continuation of firm rents has sustained inflation at a historically high 4%, even as other countries in the Gulf experienced deflation. Rental inflation, which peaked at 23.7% in July of 2008, stood at 12% in March, down for the third straight month.

According to a BSF real estate survey in April, rents in Riyadh and Jeddah are falling. Such trends are likely to bear on inflation of the rental index, which also includes fuel and water. We predict housing index inflation could fall to 7 - 8% levels later this year from March levels of 10%. The persistence of slowing but high rental inflation and rising food costs are forecast to keep Saudi inflation at elevated levels, averaging 4.7% this year compared with 5.1% in 2009, the drop owing mainly to softening rents.

We also do not expect wage inflation to be a factor this year or next due to ample labour supply in the region and Asia at lower price equilibrium. State fiscal expansion should not at this point stoke inflation and certainly not hyperinflation, but the concentration of spending among few private participants may stifle price competition in certain sectors.



May 2010



## Money supply growth at decade lows, deposits fall

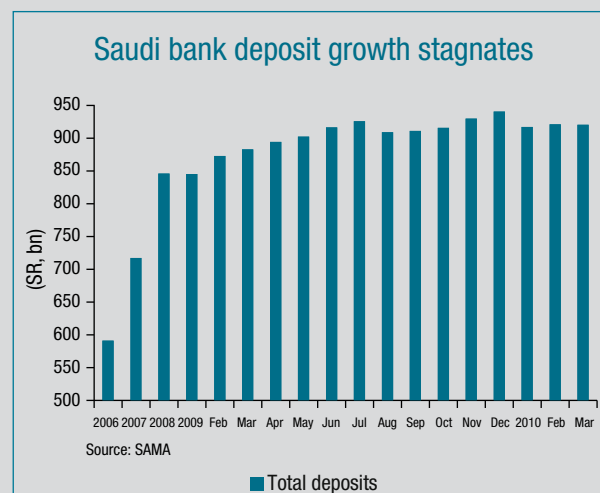
One factor that is not contributing to upward inflationary pressure in Saudi Arabia is money supply growth, which slowed to an annual 4.7% in March for broad money (M3), the slowest pace of growth in almost a decade. The main contributor to sharp declines in money supply growth from peaks surpassing 20% in 2008 has been the volume of time and savings deposits, which declined in March to SR313.71 billion, 11.9% lower than a year earlier. The pace of annual decline in savings deposits rose from 9.6% in February, while demand deposits failed to grow as quickly as earlier months, too, dragging down M3 growth. Demand deposits rose an annual 20% in March – down from February’s 21.6%.

Total Saudi bank deposits, which almost doubled between 2005 and 2009, slipped in overall value in the first quarter. Deposit growth slowed considerably in 2009, largely because the private sector was not borrowing money but instead opting to use retained earnings and cash. Although credit is an essential component of growth, the Saudi private sector is more cash endowed than others. This shift toward de-leveraging slowed the pace of deposit growth but does not represent in our view any systematic concern.

The decline in 2010 is likely due to businesses deploying money in the economy on stronger indications for a recovery. The biggest driver of the decline in deposits was lower foreign currency deposits, which dropped 18.5% from December levels. Foreign currency deposits

of government entities fell 22.4% and those of businesses and individuals decreased 14.8%. Once private sector firms are comfortable with their debt positions and start dedicating funds to expansion, they are likely to seek a funding mix combining debt and retained earnings.

Stronger economic conditions have borne positively on company earnings. For companies listed on the stock exchange, cumulative profits surged 71% in the first quarter, supported by the petrochemical sector, in which SABIC posted strong results and new companies began operations. The banking sector’s performance was out of pace with the overall trend, with banks’ combined profits in the first quarter falling more than 9% from the year earlier.



May 2010

## Why is credit languishing?

Taking robust economic fundamentals into consideration, stagnancy in bank credit is not commensurate to the size of local banks, their liquidity and the macroeconomic well being of the country. Unlike other Gulf states where banks continue to suffer the consequences of sharp property market corrections and corporate defaults, Saudi Arabia has fared very well. Its property market is undersupplied, prices are resilient and home finance accounted for only 2.6% of total bank loans as of March. Private companies have de-leveraged and, unless there is a drastic shift in global circumstances, there should be no new large skeletons of bad debt hiding in the closet.

The state, through specialised credit agencies like the Public Investment Fund (PIF) and the Saudi Industrial Development Fund (SIDF), has offered generous financial support to keep key infrastructure projects on track. By the end of March, the value of these independent organisations stood at SR585.29 billion, down 7.3% from 2008, according to SAMA data. Expansionary spending should, in theory, boost confidence of private sector investors in the economy and catalyse bank credit. But despite all of the ingredients for a perfect recipe of bank credit revival appearing to be in place, lending continues to be listless.

Typical reasons given for languishing bank credit growth are 1) banks are implementing tighter conditions on relationship lending; and 2) private-sector companies are not seeking loans as they focus instead on reducing their debt positions. These two reasons tell part of the story, but they omit two additional crucial components outside of banks' control.

Firstly, state intervention with interest-free financing, while advancing official development ambitions, fails to persuade

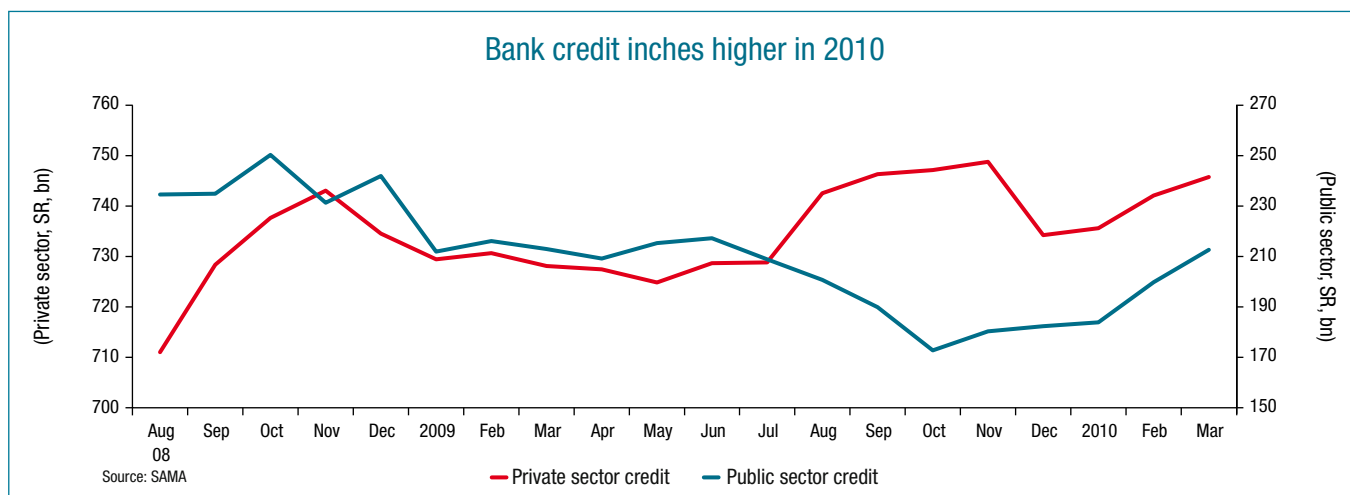
banks to jumpstart lending; the state is leaving little room for banks to partake in strategic projects in sectors such as utilities and transport. It may be prudent to reassess the state's business model to strike better balances between government involvement and private sector participation on the one hand, and interest free lending and more costly bank credit on the other. In the medium term, the economic costs of failing to involve banks will outweigh any savings in financing. The government should avoid creating a scenario where it is forced to carry the burden for economic development by crowding out most private participants in favour of a select few. Participation of mid-segment companies, including contracting firms, should be emphasised, while efforts made to achieve local content sourcing. Mid-level contractors could be granted contracts directly from the government rather than only through sub-contractors, as often happens now. Mega projects may need to be recalibrated to allow a wider pool of private participants.

Secondly, the state is re-thinking large-scale, low-risk expansion projects (particularly in energy), forcing delays in project roll outs that also impedes efforts to widen the project financing pool for banks until 2011. Project delays witnessed in 2009 hit private-sector appetite for investments and, in turn, their participation suffered.

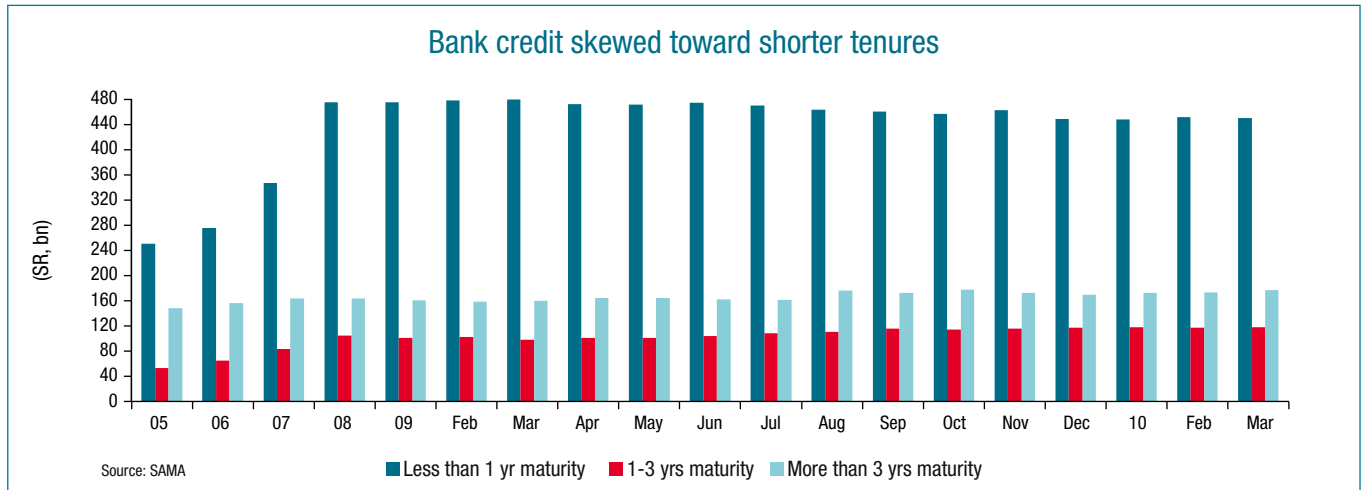
## Loan growth crawling up

There has been a turn in loan activity in 2010 after bank claims on the private sector stagnated in 2009 following a surge of almost 70% between 2005 - 2008. Lending to the public sector, too, dropped in 2009, following jumps of more than 50% between 2005 - 2008.

In March, bank claims on the private sector grew 0.5% month on



May 2010



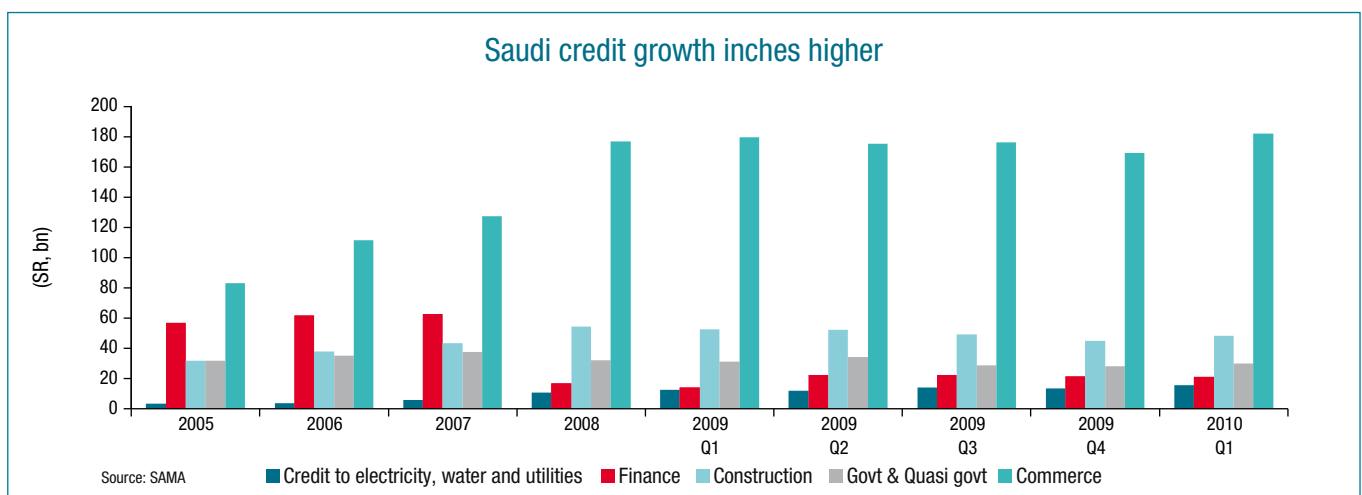
month, taking first-quarter growth to a modest 1.6%. Claims on the public sector, by contrast, expanded by a fast 6.5% in March from February, when month-on-month public sector credit growth of 8.7% was the quickest expansion since the financial crisis intensified in September 2008. Public sector credit growth can be attributed to state expansion projects, but a continuous preference for public sector credit allocation is not healthy.

We expect this measured growth will continue in the coming months, but better times will take longer to unfold than banks had initially hoped. While there are early signs that loan growth is turning, we see no triggers on the horizon powerful enough to generate substantial momentum in bank credit.

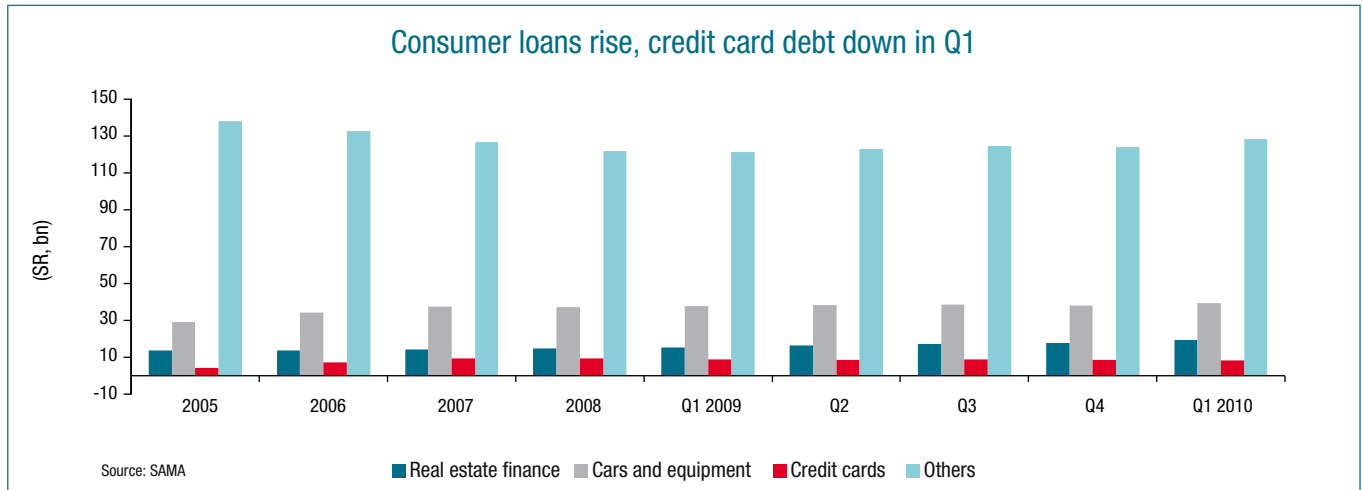
The subdued atmosphere has to do with the nature of lending that banks are comfortable taking part in. Mid-sized

contractors are complaining publicly of being unable to access adequate credit lines from banks, while banks argue they are unable to secure enough collateral or adequate securitisation to provide loans for subcontractors. In this environment, banks will not provide loans unless proper guarantees are provided.

Saudi banks have tended to concentrate on relationships with family businesses, policies that will take years to modify in order to redirect capital to SMEs. For their part, SMEs must be more suitably structured by, for instance, improving the transparency of their balance sheets. Banks have also focused on shorter-term lending, with credit maturing in three years or more accounting for only 23.8% of total loans at the end of March. This illustrates skewed demand in favour of short-term borrowing, sought by companies to meet working capital needs and guard against interest rate volatility. Short-term



May 2010



debt offers a way to take advantage of the steep yield curve that has been accentuated in the past year or so. That said, credit growth in March resulted mostly from a gain in long-term debt, reflecting the extended tenures of many projects.

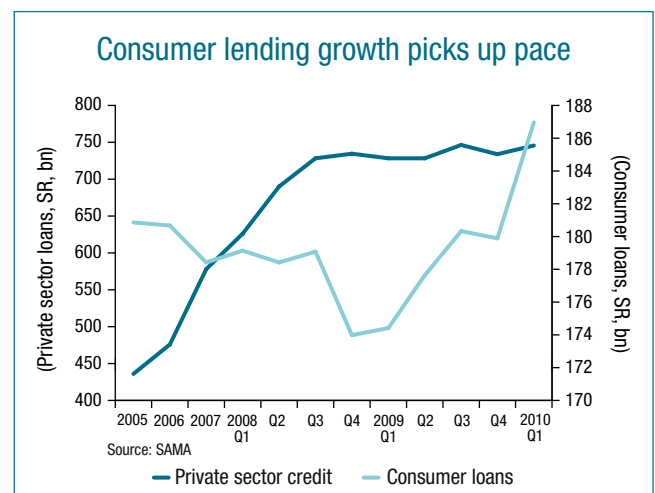
Traditional relationship lending practices were challenged last year following the debt troubles of two family conglomerates, which shocked a banking system already caught in the wave of global risk aversion. Banks were compelled to take stock of their loan books, and consider and implement revisions to relationship lending policies to make them more rigorous. High creditworthiness as a concept could no longer simply be defined by the length of the relationship, or wealth and social importance of the family.

As these new policies fall into place, the credit cycle will turn and loan expansion at Saudi banks should register modest month-on-month growth by the second half of the year, yielding overall annual credit growth of 8%. Credit growth could have expanded faster had there been a viable SME sector to lend to, although at the moment, this reality is not attainable in Saudi Arabia. Credit recoveries need not stem from large-scale private sector recuperation – they can also result from lending to SMEs if banks adopt more diversified credit portfolios.

A catalyst for a large part of the loan growth this year will be retail banking, cited as a key growth strategy among banks striving to tap high population growth and address underdeveloped retail penetration. In the years preceding the financial crisis, most loan growth was linked to project financing and corporate credit, but consumer banking has taken a bigger role since. In 2009, as private sector credit

receded, consumer lending rose to SR179.9 billion, up 3.4% from 2008 and seven-fold above 2000 levels. Between 2006-2008, total consumer lending contracted, so 2009 marked a stark shift that happened despite the overall stagnation in credit. In the first quarter, the trend continued, with overall consumer loans advancing 7% to SR186.97 billion, steered mostly by a 25% surge in home loans. Car financing rose a much slower 4.2% as banks are still coming to terms with a freeze on auto financing applied on most dealerships in 2009.

Still, the pool of retail lending remains relatively small. In our view, therefore, even as banks move away from their risk aversion and private sector firms start borrowing again, retail loans cannot alone act as a big enough catalyst to support strong credit growth.



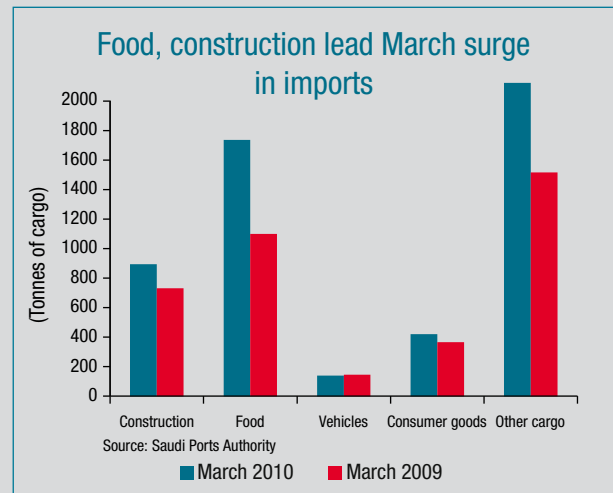
May 2010

## Trade, tourism on upward trajectory

Business and trade activity are taking turns for the better in line with the economic improvements. So far in 2010, data of the Saudi Ports Authority reveal the renewal in import flows this year as economic activity picks up. Cargo arriving and released at Saudi ports surged 53% in March compared with the year earlier while cargo loaded at ports fell 10%, data show. Businesses are building up their inventories as they anticipate better consumption patterns in the second half. Consumer good shipments jumped 14.6% from the year earlier, while construction material imports advanced 22.3%.

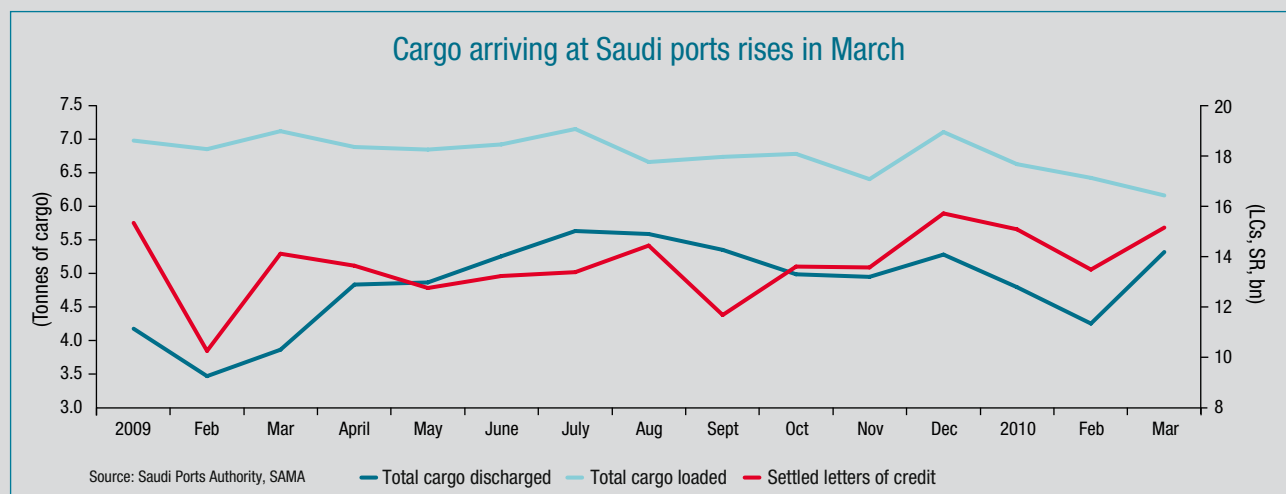
Growth in letters of credit (LCs) also provide a barometer as to the health of trade activity. The year-on-year rise in new private sector imports financed via LCs rose to 54.1% in March from 38.6% in February, according to SAMA. Settled LCs also gained an annual 7.3% in March. Imports had dropped 19% in 2009 due to the widespread slowdown in private sector activity and personal consumption, but we expect they will rise about 16% this year on the general revival in the economy. Total shipments arriving at Saudi ports fell almost 15% in 2009.

The tables have turned since late last year as more projects begin construction, demanding building material imports, while greater machinery and foodstuff shipments are coming in to cater to a growing domestic market. New LCs for financing machinery imports gained 47% in March,



while those for vehicles more than doubled and for building materials almost doubled.

Tourism is also poised to rise this year as fears over H1N1 virus dissipate and the global recovery leads to a rise in regional visitors. Tourism added 3.7% to Saudi GDP in 2009, up from 2.7% in 2008, according to preliminary data of the Tourism Information and Research Centre. Tourism, which amounted to 6.9% of non-oil GDP in 2009, centres on Islamic pilgrim traffic to the holy cities of Makkah and Madinah. Internal tourist overnight visits, including inbound and domestic tourists, fell 1.4% and the number of tourist nights dropped 15.7%, data show.



May 2010

### Saudi Arabia key projects pipeline

Deal name	Industry	Prj. Cost (USD, mn)	Expected financial close
Riyadh IPP 2400 MW	Utilities	3,000	2010
Ras Azzour WPP (EPC)	Utilities	4,000	2010
Ras Azzour WPP (water)	Utilities	5,000	2010
Al Haramain high-speed rail (phase II, III)	Transport	6,000	2010
Saudi Iron & Steel Co	Steel	2,000	2010
Medina airport PPP (BTO)	Aviation	1,000	2010
Yanbu Cement Co	Cement	n/a	2010
Tasnee acrylates complex	Petchem	1,200	2010
Petro Rabigh expansion	Petchem	3,000	2011
Yanbu refinery	Refinery	10,000	2011
Aramco-Dow Jubail petrochemical project	Petchem	20,000	2011
Maaden Alcoa project	Aluminium	5,000	2010
Maaden Alcan project II	Aluminium	4,000	2011
King Abdullah Financial District	Finance	3,900	2010
Tasnee (copper smelter)	Mining	1,000	2011
Jabal Sayid mining project	Mining	550	2010
King Abdulaziz International Airport	Aviation	4,800	2010
Madinah IWPP	Utilities	4,000	2011
Jizan refinery	Refinery	12,000	2011 / 2012
SABIC-Exxon Jubail rubber plants	Petchem	5,500	2011 / 2012
Jubail acrylics complex	Petchem	2,000	2010
Sipchem Jubail petrochemicals complex phase III	Petchem	4,000	2011
Sipchem/Hanwa Jubail petrochemical plant	Petchem	7,000	2011 - 2012
Ibn Rashud-SABIC petrochemicals complex	Petchem	1,800	2011
Arabiyah gas plant development	Oil/Gas	5,600	2011
Saudi Electricity Co Riyadh IPP	Utilities	2,500	2010
Saudi Electricity Co Qurayyah IPP	Utilities	2,000	2010
Saudi Electricity Co Rabigh IPP	Utilities	1,200	2011
Saudi Electricity Co Rabigh Power Plant expansion	Utilities	2,000	2010
	<b>Total projects</b>	<b>124,050</b>	
	<b>Total 2010</b>	<b>44,950</b>	
	<b>Total 2011</b>	<b>79,100</b>	

Source: Banque Saudi Fransi

### State lending picks up slack

For the sake of cost efficiency and ease, the government has been extending billions of riyals in interest-free loans to state-linked entities in order to keep strategic projects – such as the Al Haramain high-speed railway and electricity expansion projects – on track. With the cost of bank credit remaining at elevated levels (rising between 50 to 200 bps over the past few months), drawing on public foreign assets to bankroll projects does make sense, especially as the state strives to keep expansion on target during a period of global bank risk aversion.

This is a slippery slope, however, and the state risks tipping the balance out of banks' favour if it does not tread carefully. We have argued in the past that the government is able to

shoulder the burden of expansion costs in the short term, but to ensure adequate job creation for Saudi Arabia's growing population, the private sector must take a bigger role in investment. After all, it is the private sector that can create jobs for young Saudis not the public sector. The state has done more than enough to provide financing with the help of PIF and others, but banks need an environment where they are able to lend without duress.

The government decided in April to extend a SR15 billion interest-free loan to state-run utility Saudi Electricity Co to enable it to pursue new power projects, including expansion of the Rabigh power plant that is designed to support Makkah and Madinah. The SEC financing case may be unique given the challenges it faces to speed up its expansion capacity projects.

May 2010

But the finance ministry loan, payable over 25 years, is reminiscent of a number of deals provided by PIF, an arm of the ministry, this year. In February, the Saudi Council of Ministers asked PIF to extend interest-free loans to contracts that would speed up the completion of the 450-kilometre Al Haramain high-speed railway. Phases II and III of this project, worth \$6 billion, are due to be financed this summer. A project pipeline for 2010 of almost \$45 billion is thus deceptively large because the pool available for banks is substantially smaller.

There is a fine line between the extent of the role the government should play in financing projects before it begins to impinge on banks and, more importantly, crowd out most of the private sector. In our view, it may be prudent to explore alternative ways to finance strategic projects. The challenge is that certain businesses are close to breaching single obligor limits of banks (25% of a bank's equity), which can easily be surpassed given the scale of some projects. To avoid this, project timetables will need to be extended or the overall size of projects scaled down – neither of which seems probable. An alternative would be for authorities to offer future invoices or IOUs on some mega projects conditional on extending payments – a mechanism utilised in the 1990s for some infrastructure projects such as the Qassim Highway. Under such a scheme, the obligor is the government and funds are considered investments on a bank's balance sheet. Another option would be to collateralise credit facilities in the form of guaranteed deposits based on project progression. Cash collateral has zero risk.

The government may in any case opt to return to financial markets as pricing becomes more competitive. SEC priced its third sukuk, or Islamic bond, this month at 95 bps above the Saudi interbank rate – 68% cheaper than the yield of its last bond in 2009.

## Conclusion: Project pipeline key to credit recovery

This dilemma highlights the importance of project finance in steering bank credit revival. The pipeline for project financing mandates, however, will only pick up momentum towards the end of 2010 and 2011, later than initially expected, due partly to project delays and renegotiations. The depth of the project finance pipeline over the next two years will hence act as a crucial gauge as to when domestic bank credit growth is unlocked.

So far this year, the viability of a number of Saudi energy projects has been put to the test. In January, given the challenging economics of the project, the government called on Saudi Aramco to build the proposed 250,000 - 400,000 barrels per day Jizan refinery in south-western Saudi Arabia. The decision was taken after it received insufficient interest from global private investors in what was initially deemed an independent project.

In a bid to save costs, moreover, Saudi Aramco and Dow Chemical have decided to scrap plans for a refinery expansion at Ras Tanura, site of the world's largest offshore oil facility. The partners have agreed to move a \$20 billion petrochemical project to Jubail from Ras Tanura, scrapping the \$8 billion refinery expansion that would have doubled its capacity.

All in all, these developments are not auspicious news for banks in the short term. Contracting firms were already on the verge of winning contracts from the consortium to build the Yanbu refinery before ConocoPhillips dropped out. Financing for the project will face delays of about two to three quarters in our view. Banks had also expected to begin pursuing financing opportunities related to the Ras Tanura expansion in the coming months – another development now in temporary respite. Such postponements mean that banks are unlikely to see any money from them until the very last months of 2010 and, more likely, not until 2011.

May 2010

## Key Saudi Arabia Economic Indicators

	2002	2003	2004	2005	2006	2007	2008	2009e	2010f	2011f
<b>MACRO-ECONOMIC INDICATORS</b>										
Nominal GDP (USD bn)	188.6	214.6	250.3	315.3	356.2	384.7	475.1	369.2	422.5	478.2
Nominal GDP (SR bn)	707.1	804.6	938.8	1182.5	1335.6	1442.6	1781.6	1384.4	1584.2	1793.3
YoY % change	3.0	13.8	16.7	26.0	12.9	8.0	23.5	-22.3	14.4	13.2
Real GDP growth rate, %	0.1	7.7	5.3	5.6	3.2	2.0	4.3	0.15	3.9	4.8
Non-oil private sector real GDP growth rate, %	4.1	3.9	5.3	5.8	6.1	5.5	4.8	2.5	3.7	4.6
Government real GDP growth rate, %	2.9	3.1	3.1	4.0	3.1	3.0	3.7	4.0	4.1	3.8
Oil sector real GDP growth rate, %	-7.5	17.2	6.7	6.2	-0.8	-3.6	4.2	-6.4	4.1	5.2
Inflation, YoY % change	0.2	0.6	0.3	0.7	2.2	4.1	9.9	5.1	4.7	4.8
GDP per capita (USD)	8774	9744	11111	13645	15040	15870	19149	14880	17028	19275
<b>BUDGETARY INDICATORS</b>										
Total export revenues (SR bn)	271.7	349.7	472.5	677.1	791.3	874.4	1175.4	711.0	768.7	832.1
Oil export revenues (USD bn)	63.6	82.0	110.4	161.6	188.2	205.3	281.0	162.6	188.5	201.9
Total government revenue (SR bn)	213.0	293.0	392.3	564.3	673.7	642.8	1101.0	505.0	699.2	762.3
Total government expenditure (SR bn)	233.5	257.0	285.2	346.5	393.3	466.2	520.1	550.0	621.3	694.5
Deficit/surplus (SR bn)	-20.5	36.0	107.1	217.9	280.4	176.6	580.9	-45.0	77.9	67.8
Budget balance, % of GDP	-2.9	4.5	11.4	18.4	21.0	12.2	32.6	-3.3	4.9	3.8
Domestic debt (SR bn)	558.0	660.0	610.6	459.6	364.6	266.8	235.0	225.0	209.0	186.0
Domestic debt as % GDP	78.9	82.0	65.0	38.9	27.3	18.5	13.4	16.3	13.2	10.4
Total imports (USD bn)	29.6	38.3	43.5	53.8	63.0	81.5	100.6	81.6	94.7	109.2
Current account balance (SR bn)	44.5	87.2	184.9	337.5	371.0	350.0	496.2	99.4	173.0	228.0
Current account as % of GDP	6.3	10.8	19.7	28.5	27.8	24.3	27.9	7.2	10.9	12.7
<b>EXCHANGE RATE (=USD1)</b>										
Saudi riyal	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
<b>BANKING INDICATORS</b>										
Domestic credit growth, %	10.8	13.6	20.9	21.6	6.5	19.7	28.6	-6.1	9.5	13.2
Bank claims on private sector, YoY % change	10.0	11.0	37.4	38.9	9.2	21.4	27.1	-0.04	8.0	12.7
Broad money M3, YoY % change	14.7	6.9	18.8	11.6	19.3	19.6	17.6	10.7	13.9	12.1
SAMA net foreign assets (USD bn)	41.9	59.5	86.4	150.3	221.1	300.9	437.9	405.3	445.9	498.2
Repurchase Rate (year-end)	2.00	1.75	2.50	4.75	5.20	5.50	2.50	2.00	2.00	3.25
<b>SAVINGS &amp; INVESTMENTS</b>										
Gross fixed capital formation, % of GDP	18.1	18.4	16.7	16.5	17.5	20.5	19.6	24.8	24.5	26.7
Non-oil government investments, % of GDP	2.6	2.9	3.2	4.6	4.4	6.4	6.2	15.2	13.8	14.1
Non-oil private investments, % of GDP	13.8	12.9	11.6	10.0	9.7	6.6	8.3	10.2	10.7	12.6
Gross domestic savings, % of GDP	37.1	41.8	45.9	51.3	50.1	48.5	52.8	35.5	41.8	43.2
Government savings, % of GDP	-0.9	6.0	14.0	23.6	26.2	20.5	40.7	9.8	19.1	23.4
Private savings, % of GDP	38.0	35.8	31.9	27.7	23.9	28.0	12.1	25.7	22.7	19.8
<b>DEMOGRAPHIC INDICATORS *</b>										
Population (in millions)	21.5	22.0	22.5	23.1	23.7	24.2	24.8	25.5	26.2	26.8
Unemployment rate (%) Saudi	9.7	10.4	11.0	11.5	12.0	11.0	9.8	10	10.1	9.9
Non-Saudi	0.8	0.8	0.8	0.8	0.8	0.4	0.4	0.5	0.4	0.4
<b>OIL INDICATORS</b>										
Argus Sour Crude Index (ASCI)					59.4	66.4	93.8	60.4	76.0	82.0
Average oil price (WTI) (USD/barrel)	26.3	31.3	41.3	56.6	66.1	72.3	100.2	62.1	78.0	84.0
Average Saudi oil price (USD/barrel)	23.4	26.8	34.5	49.5	60.5	68.1	93.4	58.1	74.0	80.0
Crude oil production (million bpd)	7.1	8.4	8.9	9.4	9.2	8.8	9.2	8.2	8.4	9.1

Source: Saudi Arabian Monetary Agency, other Saudi Arabian government authorities, Banque Saudi Fransi forecasts

May 2010

## Disclosure appendix

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