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Tough funding conditions for GCC corporates: the hidden effect of lower oil prices

Tighter liquidity conditions in the GCC region since mid-2014...

Oil prices declined by around 75% between mid-2014 and January 2016, with Brent crude prices falling as low as \$28 a barrel. Since then, prices have risen back up by nearly 85%, to around \$50 a barrel. Nevertheless, persistently low prices are continuing to weigh on liquidity conditions across Gulf Cooperation Council (GCC) countries. Firstly, these countries are still heavily dependent on oil, despite efforts made towards greater economic diversification. Between 2011 and 2014, hydrocarbon revenues accounted for 70% of exports and over 80% of total fiscal revenues, on average¹. Secondly, low energy prices have been dragging down governments' fiscal revenues, which has in turn weighed on the results of corporates and the liquidity of the banking sector. As a result, both financial and business conditions have deteriorated since the beginning of the decline in oil prices. Real GDP growth across the region fell to 1.9% in 2016, down from an average of 4.9% between 2010 and 2015². Growth is expected to edge up marginally, to 2.1% in 2017, supported by the recovery in oil prices.

The slowdown in fiscal revenues and economic growth has pushed governments in the GCC region to adopt austerity measures such as raising administrative fees, reducing (or even eliminating) some subsidies, cancelling low-priority projects and trying to contain salaries. Governments are continuing to examine measures to raise additional budgets through other taxes and fees (such as VAT, taxes on business profits and income tax). The region's budgets for 2017 showed reductions

in public spending which will lead to the postponement of some important projects. This will make cash flow management more difficult for companies and reduce the opportunities for banks to finance mega-projects (one of their main sources of profitability).

Higher interest rates are another cause of tightening liquidity. GCC countries (with the exception of Kuwait³) have their currencies pegged to the US dollar. The Fed has hiked its rates four times within the last 16 months, from 0%, to 0.25%, to 1%, to 1.25%. As a result, some of the central banks in the GCC region have raised policy rates, as they endeavour to protect their currencies.

At the beginning of 2017, the Saudi Arabia Monetary Authority (SAMA) raised the reverse repo rate (the rate at which commercial banks deposit money with the central bank), from 0.75% to 1.25%. The repo rate, however, which central banks use to lend money to commercial banks, remained unchanged at 2%.

The Central Bank of Kuwait (CBK) raised its discount rate by a quarter percentage point, up from 2.50% to 2.75%. The Central Bank of the UAE raised interest rates on the issuance of its certificates of deposits and the repo rate for borrowing short-term liquidity from CBUAE against certificates of deposits by 25 basis points, increasing the latter to 1.5%.

The Central Bank of Bahrain (CBB) raised its key policy interest rate, on the one-week deposit facility, from 1% to 1.5%. The CBB has also decided to increase the overnight deposit rate from 0.75% to 1.25%, to adjust the one-month deposit rate from 1.50% to 2.15%, and to raise the lending rate from 2.75% to 3.25%. GCC central banks are likely to deliver further rate hikes, in line with any from the US Fed.

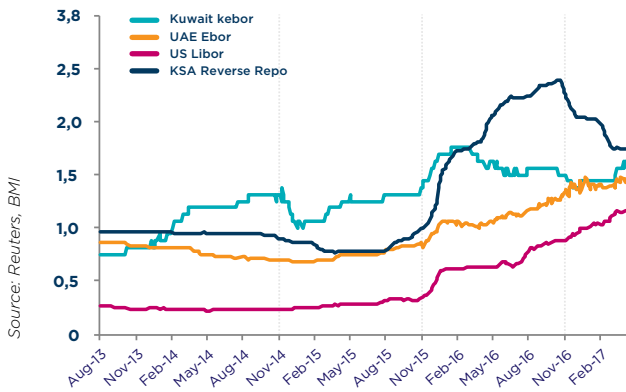
Low oil prices have forced GCC governments to use their own resources to finance budget deficits. As a consequence, UAE and Saudi Arabian government deposits have declined by 17% and 4.5%, respectively, since 2015. This fall in government deposits has starved banks of a source of liquidity which is usually cheaper than others, such as bond issues. Drawing on deposits from the banking system has been an additional cause of the region's liquidity squeeze, which has started to tighten. Between 2015 and May 2017, three-month interbank rates rose by 63 bps in Kuwait, 80 bps in the UAE and 125 bps in Bahrain. In Saudi Arabia rates climbed by around 155 bps, to 2.35% between early 2015 and mid-2016. Since then, they have fallen to 1.73%, in line with the recovery in oil prices.

The small pick-up in oil prices and the less-than-previously-expected rate hikes from the US Fed in 2016 allowed interbank rates to edge down in Kuwait and Saudi Arabia between August and December 2016 - although rates in Kuwait have since begun to rise again. The US Fed was only able to hike its rates once in 2016 - rather than the previously anticipated three or four times. This has allowed global investors to diversify their investment portfolios into emerging markets, such as Gulf countries. Nevertheless, this

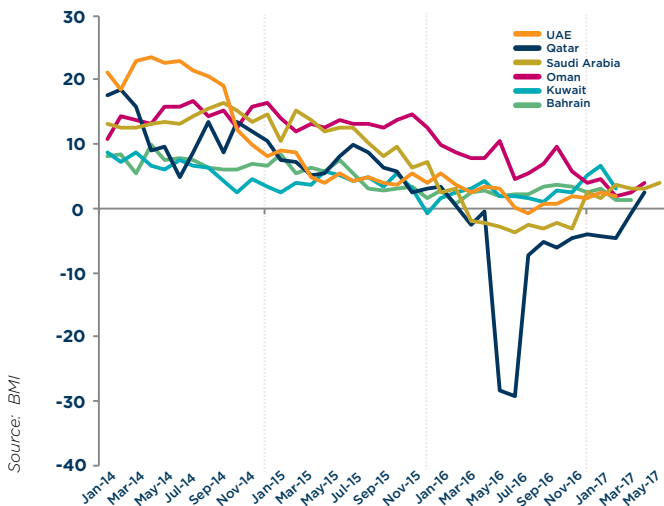
scenario looks likely to be temporary, as the Fed is expected to continue with its tightening process in 2017. Once the rate hikes have reached sufficient levels to deal with improving economic conditions, the process of reducing the size of the balance sheet will begin. Large-scale purchases of assets, such as US treasury and government-supported mortgage-backed securities, have swollen the FED's balance sheet to \$4.5 trillion, up from around \$800 billion in 2008. This means that liquidity conditions may be tighter in the upcoming period.

Between 2014 and the end of 2016, money supply in the GCC region dwindled - leaving investors with fewer monetary instruments. In Bahrain, M2 growth (considered the most reliable indicator of the availability of liquidity in the economy) inched up by 1.6% year on year, as of February. This was below its 2016 average of 2.5% y/y. In Kuwait, the annual pace of M2 growth fell to 1.4% in February 2017 (down from 2.9% in January 2017), while it rose by 3.1% in Saudi Arabia during the same time. Expansion of M2 was slightly stronger in the United Arab Emirates, as it rose from 3% in January 2017 to 4.2% in February. Nevertheless, despite these recent improvements, liquidity conditions are still tighter than they were compared to the period until 2014 (Graphic 2).

GRAPHIC 1
3-month interbank rates in GCC (%)



GRAPHIC 2
Change in M2 (yoy, %)



...are having differentiated impacts on business financing

Weak energy prices and lower government spending across the GCC region put pressure on lending opportunities. The stagnation of oil prices at low levels means that liquidity conditions in the region could remain tight, with higher funding costs. More restricted government subsidies would exacerbate the slowdown in deposit growth. Some of these pressures are being alleviated by the resilience of non-oil sector and the global economic recovery. Nevertheless, higher interest rates could still dampen growth perspectives. Overall, loan growth is expected to be 4.9% in 2017 - a figure which, while still solid, is far lower than the average annual growth of 9.2% recorded between 2012 and 2016⁴.

Asset growth in the region stabilised at around 6.4% in 2016, compared with 6.6% for Islamic banks and 6.9% for conventional banks in 2015 (according to the ratings agency Standard and Poors, which also expects asset growth to fall around 5% this year, mainly due to the fiscal tightening⁵). Restricted resources would make banks more selective on granting loans in 2017 and 2018. This would also limit access to funding for corporates, especially for small and medium-sized companies, as they represent higher risks.

The effects of this liquidity squeeze vary between the GCC countries. In Oman, annual bank asset growth fell by 4%, while the interbank deposit rate rose to 0.55% (up from 0.28% in February), narrowing banks' profitability. Government deposits decreased by 6.9% yoy in February, while private sector deposits only increased by 4.6%⁶. In Saudi Arabia, growth in client loans declined to 2.9% yoy in February - far below the average annual growth of 10% recorded between 2012 and 2016⁷. In order to address Saudi Arabia's liquidity issues, in September 2016, the Saudi Arabia Monetary Authority (SAMA) provided around \$5.3 billion to local banks, in the form of time deposits on behalf of government entities. SAMA also introduced 7-day and 28-day repo agreements, to support banks in funding the private sector. In Kuwait, public investments will be the main drivers of loan growth,

1 - The Impact of Oil Prices on the Banking System in the GCC, WP/16/161, IMF
 2 - Coface forecasts
 3 - The Kuwaiti dinar exchanges against a basket of currencies which is believed to be heavily dollar dominated.
 4 - Economic Slowdown Weighing On GCC Banks' Outlook, April 2017, BMI Research
 5 - GCC Islamic banks' growth expected to moderate in 2017-18, April 2017, Gulf News

as government spending gives banks the opportunity to lend to large infrastructure projects. Within its five-year development programme, Kuwait's government has pledged to spend around \$106 billion between 2015 and 2019. Nevertheless, fiscal consolidation will continue to create a challenging operational environment for banks and corporates.

In Qatar, client loan growth is expected to remain stronger than the rest of the region, on the back of large-scale government investments which are supporting the demand for loans. Qatar's real GDP growth is expected to stand at 3.4% for 2017, as the diplomatic rift between Qatar, Saudi Arabia and Saudi allies is expected to be relatively short-lived with limited impact on the economy. The growth would particularly be driven by the Qatari government's spending on World Cup-related infrastructure projects. It is expected that this government spending will support loan growth over the upcoming period, although loans will mainly be granted to the public rather than the private sector (making funding a potential issue for businesses). In 2016, interest rates on government securities averaged 1.99% - substantially lower than the 5.95% rates on private sector loans. This led to higher funding costs for businesses⁶. As of April 2017, non-resident deposits in Qatar's banking system accounted for 24.3% of total deposits (781 billion riyals), according to data from the central bank. This ratio was only 5.5% in June 2014, just before oil prices began to plunge. This situation indicates that the banking system has benefited from abundant global liquidity conditions to compensate for the lower public deposits caused by falling energy prices. Nonresident deposits currently play an important role in financing Qatar's current account deficit - but it also makes the country's liquidity position vulnerable to external financing conditions. According to the S&P ratings agency, the average maturity of these deposits is under one year.⁷ The recent embargos on Qatar, which were implemented by several countries in June 2017, could have negative impacts on these funds, as non-residents may opt to withdraw their deposits from Qatari banks (although no financial sanctions have been implemented so far). This situation could result in tighter liquidity conditions, forcing the government to step in by using public funds. If rolling over these external liabilities becomes harder for banks in the upcoming period, then the banking system's balance sheet would shrink, reducing liquidity. In the UAE, bank lending growth approached an average level of 8% between 2012 and 2016, mainly due

to the Emirate's diversified economic structure and government-driven infrastructure projects, such as Expo 2020. With recovering energy prices, bank lending is expected to record a slight pick-up over the coming quarters - a situation which would be of benefit to the private sector.

Lending in Bahrain bottomed out throughout 2016 and the annual pace of growth declined down to as low as 1% in January 2017 (compared with its average of 5% between 2012 and 2016). The economic slowdown in Saudi Arabia, with which Bahrain has close economic ties, is weighing on Bahraini businesses. Compounded by low energy prices, which account for around 80-90% of government revenues, and rate hikes from the US Fed, liquidity in the banking sector is expected to remain tight, with subdued loan growth in 2017.

Overall, liquidity conditions and business funding have been negatively affected throughout the GCC region, due to weak oil prices. Interbank rates have increased and money supply has slowed across the region. This situation has been particularly a concern for Oman and Bahrain, as they have lowest fiscal and external buffers in the region. This means that tightening liquidity conditions have had a deeper impact for corporate financing in these two countries compared to others, such as the UAE and Saudi Arabia, which benefit from stronger financial buffers. The more diversified structure of the UAE's economy has allowed it greater independence from oil exports.

Capital markets to play bigger role in fundraising

Fiscal consolidation, the slowdown in economic performance and the drawing of public deposits in the banking system have pushed GCC governments to tap international bond markets, in order to ease liquidity pressures and find additional sources that could be used for the private sector. Saudi Arabia issued \$17.5 billion in Eurobonds in October 2016, at five, ten and 30-year maturities. Oman raised \$2.5 billion in June 2016, through the issuance of five-year notes and 10-year bonds. It also sold \$5 billion in bonds earlier in 2017. Qatar sold \$9 billion of Eurobonds across maturities of five, ten and 30 years, while Abu Dhabi raised \$5 billion in May 2016.

CHART 3
Change in M2 (yoy, %)

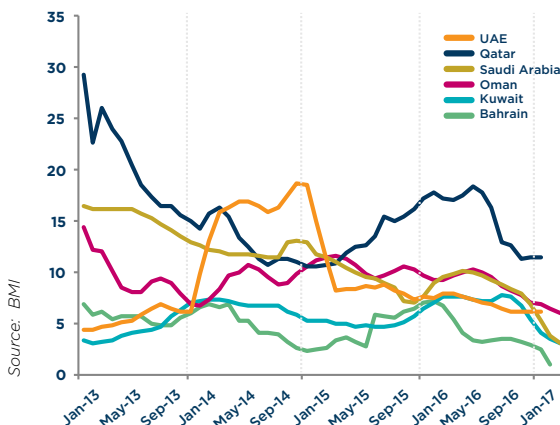
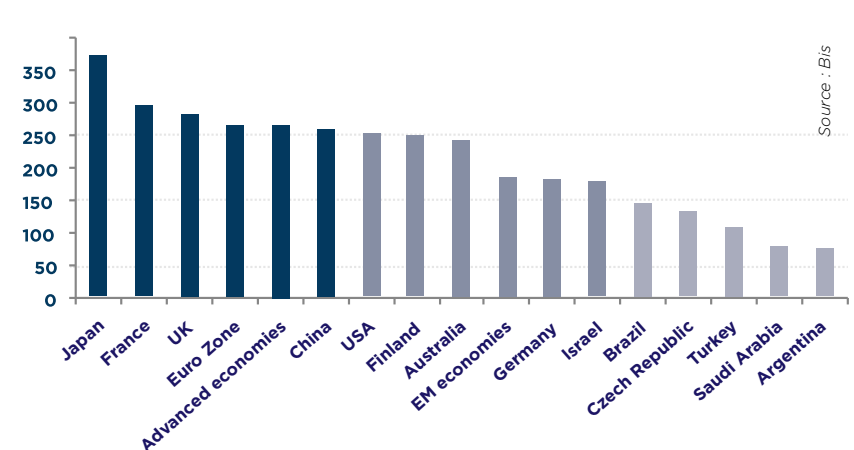


CHART 4
Total credit to the non-financial sector, % of GDP (Q4 2016)



6 - Banking Sector: Tougher Environment Over Coming Quarters, April 2017, BMI Research

7 - BMI Research

8 - Robust Loan Growth Ahead, But Sector Profitability Remains Under Pressure, March 2017, BMI Research

Overall, GCC governments raised a total of \$38.9 billion through international bond issues in 2016. Governments are expected to continue to tap bond markets in 2017, despite the recovery in energy prices and lower fiscal deficits. The pace and size of issuances is however expected to moderate. In 2017, GCC sovereign bond issuance is expected to be \$32.5 billion, according to ratings agency Moody's⁹. A pick-up in growth rates, combined with governments' needs for investing in infrastructure projects, would be key drivers in the search for external funding. Clearly, however, it is the level of oil prices that will be the main determinant in funding needs.

Rising investor demand for sovereign debt issues has encouraged corporates to tap international markets. According to data from the Bank of International Settlements (BIS), in Q4 2014, total outstanding international debt securities from non-financial corporations stood at \$7 billion in Saudi Arabia, \$4 billion in Qatar and \$35 billion in the UAE, compared with, respectively, \$6 billion, \$6 billion and \$28 billion in Q4 2013. This is further evidence of the willingness of corporates to benefit from international funding to meet their liquidity needs, at a time when liquidity conditions are becoming tighter across the GCC region.

Companies have also implemented other alternative financing options, such as initial public offerings (IPOs). Nevertheless, lower business confidence, regional uncertainties and fiscal consolidation measures have

weakened the performance of IPOs across the region. In 2016, there were only four IPOs (the lowest since 2010), with a total value of \$782 billion (the lowest value since 2013¹⁰). In its "Vision 2030" initiative, released in April 2016, the Saudi Arabian government announced its intention to raise around \$200 billion through privatisation programmes across several sectors including oil, healthcare, airports and education. The Kingdom is also preparing to sell Aramco, the state oil producer, which has been valued by the authorities at \$2 trillion.

Tighter liquidity conditions have also encouraged business owners to turn to private equity funds to meet their capital needs. 244 disclosed investments were made in the MENA region in 2016, compared with 175 in 2015 and 72 in 2014, according to the data from the MENA Private Equity Association¹¹. The value of disclosed investments stood at \$1.1 billion in 2016, compared to \$1.5 billion in 2015. The UAE attracted 62% of total investments in MENA, by value, in 2016, due to the country's stability and more diversified economic structure. Saudi Arabia's share declined considerably, down to 9% in 2016 from 21% in 2015¹², as the country was hit by lower energy prices and uncertainties over fiscal consolidation measures. Private equity transactions mainly targeted consumer driven sectors such as retail, healthcare and education, as oil-related sectors continued to represent higher risks. The transport sector accounted for 32% of investments (by value), with 16% accorded to retail and 14% to information technologies.

9 - GCC sovereign Eurobond issuance expected to remain high in 2017, but below 2016 record, March 2017, Moody's

10 - Capital Markets and Accounting Advisory Services, PwC, 28 March 2017

11 - The 11th Annual Private Equity and Venture Capital Report, MENA Private Equity Association, 2016

12 - The 10th Annual Private Equity and Venture Capital Report, MENA Private Equity Association, 2015

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