SELLING SAUDI-ARAMCO

Necessity or Opportunity?
In early January 2016, the government of Saudi-Arabia made a dramatic proposal, namely to consider privatizing state-owned oil producer Aramco. Some valuations of Aramco would make it the world’s most valuable company, which would make any initial public offering a major financial event. Aramco is not only the most important Saudi company in financial terms, it also is a national symbol of pride and an essential pillar of economic security of the Saudi kingdom.

While hydrocarbon prices are experiencing a severe downturn, the question is whether the Kingdom will find financial conditions compelling enough to relinquish partial ownership of the ‘crown jewel’ among state companies. The overwhelming purpose of this IPO would be to raise funds to finance government deficits during the oil trough. However, it is also important to recognize other positive externalities stemming from a partial sale of Aramco. These revolve around capital market development and include distributing wealth to Saudi investors; accelerating the development of Saudi-Arabia’s equity market; and promoting wider structural reforms, especially among state-owned enterprises. It is therefore important to also identify other policy goals that can be supported by carefully designing measures that could transform the country’s capital markets. The final section of the paper lays out some ideas how reforming Aramco could provide a politically efficient impetus to promote an equity culture among Saudi citizens, impose market forces on state-owned enterprises and boost regional financial development.

In response to public discussions of a possible float of Saudi-Aramco, this paper estimates Saudi-Arabia’s fiscal gap until 2020 with average oil prices ranging from $30–$60 per barrel. In our view, despite large fiscal deficits, there should be no hard pressure on the Saudi government to sell any unlisted assets by 2020 — particularly Aramco. Selling any public infrastructure or a fraction of Aramco would have to be an active policy choice. It could serve the broader purpose of privatization, be a vehicle to bring in foreign expertise, be a part of wider industrial and economic development policies or simply an effort to draw in more Saudis as active stakeholders in the country’s future. Nonetheless, if oil prices remained very low beyond 2020, the choice would fade and the country would need to monetize unlisted prize assets such as Aramco as well.
What is the Kingdom’s Fiscal Gap?

When evaluating the potential IPO size of Aramco, one needs to first assess what Saudi-Arabia’s fiscal position will be in the medium term. The government funding gap is the sums of all budget deficits, which are dependent on average oil prices and other economic variables. At State Street Global Advisors (SSGA), we modelled different scenarios to forecast the total funding gap for four years from 2016 to 2019. For this, we have created three distinct scenarios [detailed assumptions available in grey box below]: 1) different average oil prices for the four-year period 2016–2019 ($30; $45; and $60); 2) a gradation of respective fiscal policy responses that would cut expenditures and lift non-oil revenues; and 3) residual balance of reserves (mainly from balance of payments effects). Figure 1 below shows the funding gap in each of these scenarios.

What are the Financing Options?

In principle, there are four financing options. The first — fiscal consolidation, by which governments lower financing needs through expenditure cuts and revenue boosts — is already included in the scenario modelling above. For example, energy subsidies alone consumed nearly 10% of GDP (roughly $65 billion) in 2015. This leaves policymakers the choice to find a combination of three measures for financing: issue debt, draw down savings and/or sell assets. The latter category would be the purpose of any Aramco sale, but only comes into consideration after the government has determined the acceptable level of public debt burden, public savings levels and any alternative asset sales.

With regard to debt issuance, any public debt management strategy needs to balance several aspects. First, what is the comfort zone for overall debt levels? This typically is not only related to headline gross debt-to-GDP ratios, but more importantly about net debt-to-GDP ratios (i.e. debt minus liquid assets) and debt servicing burden (cost of interest payments relative to government income). Second, what is the appetite for debt in the respective markets? In this case, markets are international bond markets, domestic bond markets and the domestic banking system — each also highly variable to debt type issued with regard to maturity, currency, size, sukuk versus conventional etc. In short, how much debt does the state desire to carry and how much can be issued?

From a policy perspective, the Saudi government has indicated a clear preference for minimizing public debt levels. Saudi-Arabia was the international exception during 2003–2014 when it chose to pay down debt during an era of low interest rates. It is not clear what debt levels are deemed acceptable, and notably, how Riyadh considers the trade-off between asset sales and debt issuance. While gross debt levels could easily approach 50% of GDP, Saudi-Arabia will most likely still remain in a net foreign creditor position for the foreseeable future, i.e. will have the policy flexibility of selling assets versus raising debt. Or in plain English, given that Saudi-Arabia’s net savings are currently estimated between 85%–120% of GDP, the country can choose to pay from savings or raise debt.

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**Figure 1: Estimated 2016–2019 Funding Gap of Saudi-Arabia’s by Oil Price Scenarios**

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<td>1</td>
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<td>2</td>
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<td>3</td>
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The above estimates based on certain assumptions and analysis made by SSGA. There is no guarantee that the estimates will be achieved.

**Assumptions**

For each scenario ($60/$45/$30), we also calculated the 2019 year-end balance of foreign reserves (respectively: $476bn/ $397bn/$393bn) that reflected average annual current account deficits of (2.2%)/(5.3%)/(8.8%) of GDP respectively. In addition, we presumed respective fiscal policy responses (respectively ‘$60’/’$45’/’$30’) which refer to the policy mix of expenditure cuts and revenue-raising measures:

• ’$60’ foresees core subsidy cuts and smaller capital expenditures (expenditures reduced to an average of SAR 966 bn from a 2014 high of SAR 1,109 bn) as well as slight boosts to non-oil revenues based on existing revenue channels.

• ’$45’ includes all aforementioned measures, plus current expenditure cuts in real terms, minimal capital expenditures (expenditures reduced to an average of SAR 935 bn from a 2014 high of SAR 1,109 bn) and the introduction of new taxes.

• ’$30’ includes all aforementioned measures plus select current expenditure cuts in nominal terms (expenditures reduced to an average of SAR 875 bn from a 2014 high of SAR 1,109 bn) and the introduction of select non-labour income and consumption taxes (albeit at very low levels). Any underperformance in policy response would see the funding gap rise.

Due to differing policy responses, the fiscal gap decelerates as oil prices drop further. This is due to the sharper adjustment in expenditures and greater austerity imposed in those scenarios.
Selling Saudi-Aramco: Necessity or Opportunity?

While the debt management strategy remains uncertain, it is possible to estimate market demand for Saudi debt. Starting with the Saudi banking sector, there is great potential demand since Saudi banks entered this oil downturn with high levels of liquidity. Standard & Poor’s estimates that Saudi banks could easily buy up to another $80 billion of public debt without much effect on their balance sheets, and possibly up to $140 billion if they returned to average 1993–2003 levels. Current monthly issuance is approximately $5 billion which would equate to $60 billion for this year alone and place it among the world’s 15 largest issuers. Recent evidence already points to government awareness of sustaining bank demand for government paper, with the government introducing floating rate bonds. In Saudi-Arabia’s historical experience from pre–2003, other bondholders, including domestic retail and institutional investors as well as foreign portfolio investors, have absorbed between two to three times of debt compared to Saudi banks. Given that this is the beginning of a debt issuance cycle, one could presume that absorption could be closer to the lower end of the historical experience, so closer to twice the amount of bank demand. In total, it is thus reasonable to expect about $240 billion of cumulative market capacity for Saudi debt by early 2020, without having a noticeable destabilizing effect on the wider economy or capital markets.

Figures 2–4 illustrate the significant size of Saudi-Arabia’s financing options based on savings and other liquid assets. Saudi-Arabia therefore has much financing flexibility in the medium-term. In scenario 1, debt issuance alone could be sufficient to cover the total funding gap, but this would not be the case in scenarios 2 & 3. Yet even in scenario 1, it would be unlikely that the Saudi government would maximize its possible debt financing as this would complicate debt management strategy. It would prevent the build out of a full sovereign yield curve and presumably lead to heavier issuance on the short-end of the curve, carrying high rollover risk for the sovereign. Instead, government is likely to utilize many other levers. For example, the government could still tap into residual savings deposited at SAMA (sometimes also referred to as excess reserves, i.e. reserves that are above the minimum level to maintain a credible exchange rate peg plus additional buffer to withstand market speculation, which we estimate close to $200 billion), even though they will have declined considerably due to an expected worsening of the current account.

At the same time, if international investors were to purchase Saudi government debt, this would lead to capital inflows with foreign currency deposited at SAMA. In particular, if foreigners bought local currency debt, these additional foreign currency deposits would have no corresponding foreign currency liability. In short, reserves could rise beyond projected levels, so flexibility could be slightly greater than implied here.

Figure 2: Scenario 1 ($60 Oil): Saudi Arabia’s Cumulative Funding Gap versus Financing Options

![Figure 2](https://example.com/figure2.png)

**Source:** SSGA Research, estimates as of 8 March 2016. The above estimates based on certain assumptions and analysis made by SSGA. There is no guarantee that the estimates will be achieved.

Figure 3: Scenario 2 ($45 Oil): Saudi Arabia’s Cumulative Funding Gap versus Financing Options

![Figure 3](https://example.com/figure3.png)

**Source:** SSGA Research, estimates as of 8 March 2016.
For additional asset sales, the government could first turn to selling its liquid equity stakes trading on the Saudi stock exchange, estimated at roughly $120 billion.7 The gradual opening of the country’s stock market to global investors makes this a credible option over the coming years as such sales would be considerably easier than any partial floating of Aramco, both in operational and political terms. In this regard, it is safe to assume that at least one third the portfolio could easily be liquidated on short notice, i.e. about $40 billion.

Long story short: by 2020, we foresee no hard pressure on the Saudi government to sell any unlisted assets—particularly Aramco. Selling any public infrastructure or a fraction of Aramco would have to be an active policy choice. It could serve the broader purpose of privatization, be a vehicle to bring in foreign expertise, be a part of wider industrial and economic development policies or simply an effort to draw in more Saudi residents as active stakeholders in the country’s future. Nonetheless, if oil prices remained very low beyond 2020, the choice would fade and the country would need to monetize unlisted prize assets such as Aramco as well.

Actively Promoting Financing Options — How to Enable a Virtuous Cycle?

While the sale of unlisted assets may not be a matter of immediate urgency, it could have two interconnected positive consequences. In particular, a carefully executed partial sale of Aramco could be a catalyst for economic development. First, it could help drive foreign investment. This would be particularly valuable in times of current account deficits as it would alleviate pressure on SAMA to deplete foreign reserves. Second, the sheer size of any Aramco float, combined with the company’s future financing needs, could accelerate the deepening of the country’s domestic capital markets. In other words, privatization could help set off a virtuous cycle: privatized state assets would help bring about greater depth to the Saudi-Arabia’s equity and debt markets, which in turn would help attract foreign capital, which in turn would help deepen and advance capital markets.

Attracting Foreign Investors

In June 2015, the Saudi stock exchange was opened to foreign investors. This was done in a gradual and limited fashion under a qualified foreign investor program, with access to be expanded in the future when other financial infrastructure improvements have been completed. In this context, the listing of Aramco would deliver a strong signal of commitment on the part of the Saudi authorities to further develop their stock market. Given the recent opening to foreigners, this would also double as a ‘welcome’ to foreign capital. Moreover, in practical terms, an initial public offering (IPO) of Aramco’s downstream operations would already be large enough to have a substantial impact on the Tadawul’s market capitalization and liquidity, making it more attractive to foreign investors. In particular, a dual listing with a developed market stock exchange could help advance Tadawul’s international recognition and presumably result in slightly higher valuation of Aramco as well.

Saudi-Arabia’s history of foreign direct investment (FDI) also suggests that there are plenty of other sectors of interest to foreign investors. Petrochemicals, agrochemicals, non-energy mining, plastics and other industrial sectors have already proven appeal among international investors. In the past, the only way for foreign participation was through FDI, but providing platforms for portfolio investment would likely increase overall capital inflows. Index inclusion would further amplify such investment flows.

Figure 4: Scenario 3 ($30 Oil): Saudi Arabia’s Cumulative Funding Gap versus Financing Options

Source: SSGA Research, estimates as of 8 March 2016. The above estimates for Charts 3 and 4 are based on certain assumptions and analysis made by SSGA. There is no guarantee that the estimates will be achieved.
Selling Saudi-Aramco: Necessity or Opportunity?

This could be particularly valuable from a macroeconomic perspective. Post–2008, Saudi-Arabia has witnessed an annual average of $15 billion in net portfolio investment outflows. During an oil boom, it makes sense that the country would be investing excess capital abroad but in an oil downturn, it would be imperative to lower that imbalance. In this regard, foreign portfolio flows into Saudi stocks or debt would help finance current account deficits and thus preserve foreign reserves. Of course, such channels require careful regulatory calibration to ensure they do not provoke volatility in crisis times, so authorities could consider building in safety buffers to prevent that outcome.

Deepening Domestic Capital Markets — Ideas for Equity and Bond Market Development

As implied above, these trends carry great implications for Saudi-Arabia’s capital markets. But even in the absence of foreign investment, many entities in Saudi-Arabia could follow Aramco’s example and will be looking for new sources of financing, and especially, equity finance should grow in popularity. In particular, equity markets should be further stimulated by increased floats stemming from government divestments of existing holdings as well as the addition of unlisted companies.

Here, the government will have to be systematic and methodical in how it divests the pipeline of state assets in a manner that is incremental, mitigates inflationary pressures and helps to contribute a wholesome equity and savings culture among the wider citizenship. Experiences elsewhere have shown that governments can package privatized shares into a tracker fund where citizens are able to purchase units at a discount to net asset value as part of a wealth distribution program. A similar exercise was conducted in Hong Kong with the creation of the HK Tracker Fund. Such a fund would alleviate any political controversy over the sale of prized assets, while still mobilising domestic capital. A similar idea could be to create a special ETF composed of state-owned enterprises with a large weighting by Aramco. This could accelerate privatization and impose greater market forces on the entire sector, triggering less resistance by individual vested interests.

The growth in equity markets could also be a positive impulse for local bond markets. This has the potential to be greater than in the previous low oil price era due to the globalization of financial markets and the need for foreign buyers of Saudi debt. Notably, debt markets will not only consist of Saudi government issuances, but public austerity will likely constrain public investment levels which will filter through a plethora of Saudi state-owned enterprises and their supply chains. Consequently, these entities will need to develop alternative sources of financing and will increasingly turn to bond markets as the banking sector’s lending capacity will most likely be crowded out by public debt. A major issuer is likely to be none other than Aramco itself and it has already indicated the first multi-year bond issuance program. In this respect, Aramco may rely on or help build out the Saudi yield curve. Capital import needs and the concurrent internationalization of Saudi’s equity market also make this an auspicious time to facilitate bond market participation by foreign players.

One major policy challenge could be how to mitigate market volatility in nascent debt markets as well as develop a stable demand base. In this regard, since Saudi financing needs will have parallels throughout the region, Gulf Cooperation Council (GCC) countries would be well advised to consider lessons learned in Southeast Asia. There, eleven central banks cooperated to create a regional bond index fund (Pan-Asian Bond Index Fund — PAIF), which greatly facilitated private sector participation in bond purchases. In particular, it accelerated capital market development as it enabled offshore investment into bonds even if local regulatory frameworks were incomplete. In other words, creating a GCC Bond Index Fund or similar could work for the GCC states now as they all advance their capital markets regulation.
Conclusion

Saudi Arabia benefits from multiple options to finance budget deficits arising from lower oil prices in the medium term. Under scenarios in which oil prices in 2016–2019 average $30–$60 a barrel, a flotation of Aramco is not absolutely critical, given other financing sources. This is particularly the case as the potential for reduced budget deficits exists via other policy actions. However, Saudi Arabia may wish to use the era of lower oil prices to further develop its bond and equity markets, and to attract foreign portfolio flows into the Kingdom. In such a scenario, partial privatization of state assets are a viable financing option, which could both raise funds and develop Saudi capital markets. In this regard, Saudi-Aramco could play a disproportionately large role.
This is a methodological question of what to include under liquid government assets. Year-end foreign reserves alone constituted about 86% of 2015 GDP, but if other liquid assets such as government pension funds and liquid equity stakes in state-owned enterprises are included, the figure is closer to 120% of GDP as done by S&P at “Ratings on Saudi Arabia Lowered to A-/A-2; Outlook Stable”, accessed at http://www.standardandpoors.com/en_US/web/guest/article/-/view-pdf/1570327


4 “Saudi Arabia to introduce floating rate bonds”, Reuters Zawya, 18 February 2016, available online at http://www.zawya.com/story/Saudi_Arabia_to_introduce_floating_rate_bonds-TR201602180DSNIV00018X3

5 Larger domestic issuances, especially if absorbed by banks, could crowd out private sector lending and lower economic trend growth. Larger international issuances could disrupt debt management plans and lead to sudden jumps in yields, which could have the effect of higher interest rates throughout the economy if the sovereign yield curve were to rise.

6 Drawing on recommendations laid out in “Assessing Reserve Adequacy: Specific Proposals”, IMF Paper, April 2015, we combine sufficient coverage of monetary base, import costs; export share (terms of trade shock absorption capacity); and short-term liabilities. For this paper, SAMA accounting has been simplified. In practice, fiscal authorities have direct access to government and public sector deposits on the liability side of SAMA’s balance sheet, but these are all components of the SAMA’s foreign reserves on the asset side.


8 Saudi Arabia Monetary Agency.

9 De Montpellier, Louis and Hentov, Elliot, “To Borrow or Not To Borrow”, State Street Global Advisors, August 2015, p.4.

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