PERSPECTIVE

A Vision for Saudi Arabia's Future

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Whenever I arrive in a country, I like to read the local press reports to see the issues of the day. In Saudi Arabia, it was clear that one of the biggest issues—if not the biggest issue—in the news was oil prices and their impact on the economy. When oil prices began to decline from their peaks in 2014, Saudi Arabia's financial health began to face great pressure. Rating agencies downgraded the country's debt ratings because of the negative impact of the continued low-oil-price environment on its fiscal and external balances.

In May, I attended the Euromoney Conference in Riyadh, which took place under the patronage of the Ministry of Finance and was supported by the Ministry of Economy and Planning as well as the Capital Markets Authority. Top leaders discussed a series of economic and market reforms that could attract billions of foreign investor dollars to the Kingdom, and I had the pleasure of giving an interview on stage at the conference encouraging reform and expressing optimism for the future of the country's capital markets. The Saudi finance minister reported that the Kingdom had continued to pursue structural reforms even in the face of a challenging global environment and that the financial condition in the Kingdom was very stable. Nevertheless, the country's finances were under pressure due to the collapse in oil prices, prompting deep budget cuts and energy subsidy reforms. The situation certainly warranted attention, and a proposed solution came in four numbers: 2030. This spring, Saudi Deputy Crown Prince Mohammed bin Salman announced the "Vision 2030" plan to transform the economy away from oil dependence in the next 14 years.

The plan has three themes: "A Vibrant Society," "A Thriving Economy" and "An Ambitious Nation." Each area offers an ambitious blueprint to drive Saudi Arabia into the future—one that is more economically diversified. With the unveiling of the Vision, the Deputy Crown Prince announced plans to end its "addiction" to oil in as little as four years' time. This marks a very ambitious attempt which is unprecedented in Saudi Arabia's history. His idea is to rapidly develop the private sector and service industries so Saudi Arabia could "live without oil" by 2030. Both print and social media in Saudi Arabia have drawn attention to past problems, including stalled projects. The new program recognizes these historical issues and includes the establishment of an office for the administration of projects.

Goals within Vision 2030 include raising the private sector contribution to the economy from 45% to 60% and cutting unemployment from 12% to 7% within the next 14 years.

Observers have remarked on the personal authority of the 30-year-old son of King Salman bin Abdulaziz and how he has been making very important decisions. But he will likely be running up against resistance from parts of the royal and clerical establishments in what is a fundamentally conservative country. Some wonder if the scope of the transformation envisaged is possible in a country that has become accustomed to the state providing cradle-to-grave services. With half the state budget reserved for public-sector salaries, shifting even part of the wage bill to the private sector would ease fiscal pressure, but these newly created independent businesses might well choose to cut bloated staff levels, creating sources of unrest. In neighboring Kuwait, for instance, oil workers had recently gone on strike to protest modest reforms that they feared would lead to a cut in salaries and benefits. Of course, there was a lot of discussion about Vision 2030 and these sorts of issues at the conference in Saudi Arabia I attended, but there was a great sense of enthusiasm for it.

Market Reforms = Wider Access

As global investors, of course market reforms are of keen interest to us, and the Saudi Arabian stock market regulator (the Capital Market Authority) has agreed to change some of the rules for foreign investment as part of its efforts to open the country's capital market under the economic diversification plan. In the past, foreigners were not allowed to make direct investments in the market and had to use Saudi proxies (P-notes) to make investments. Then the door was opened slightly in a QFI (Qualified Foreign Investor) program, which allows a foreign investor to invest as long as he had assets of at least US$1 billion (cut from the original US$5 billion). Also, the prior foreign ownership limit of 5% of the shares outstanding in a single company will be raised to 10%, which should also encourage wider foreign participation.

One reform includes changing the trade settlement cycle from T+0 to T+2, which means trades (T) that currently must be settled the same day (0) could be settled in two days. Same-day settlement is next to impossible for foreign investors who need to work through custodial banks that hold the securities on their behalf, so this reform should help encourage wider participation. Another reform involves elimination of cash pre-funding requirements, which again is disadvantageous for foreign investors who can't have money tied up in the country waiting for a trade to take place. A further planned change is the introduction of proper delivery versus payment (DVP). Currently, delivery does not take place simultaneously with payment and vice versa, which is quite risky if one of the parties to the deal fails to deliver.

These are certainly positive developments, in our view, and are in line with what has been a gradual market opening. They also set a clearer roadmap to an eventual inclusion in the important MSCI Emerging Markets Index, which in itself will likely be transformative for the index and the emerging-market universe given the large size of the Saudi stock market—one of the world's largest with a market capitalization of more than US$380 billion.[1] Liquidity is an important factor, and while average daily liquidity of Saudi shares is already high, if more shares are listed, we think the stock exchange would be even more attractive to foreign investors.

Thus, there was considerable excitement upon the announcement of the possible sale of shares in a state oil producer, one of the world's largest oil companies, as part of the broader economic transformation outlined in Vision 2030. While Prince Mohammed has stated there would likely to be less than 5% of the company sold (as early as 2017), the listings, which would be in multiple markets including the Tadawul exchange, could be the world's largest publicly traded firm and also could generate a short-term cash windfall in excess of Saudi Arabia's projected 2016 budget deficit of US$87 billion.[2]

This has spurred hope of other privatizations, since Prince Mohammed said the government was "in the process of determining additional sectors" that are suitable, including state-run hospitals that would be placed in a holding company and "put forward for an initial public offering (IPO)" as part of a plan to transform the health ministry from a health care provider to a regulator by spinning off its hospital operating assets. The state-owned flour mill and grain storage company has also been identified as a possible IPO candidate.

Some Saudi officials have expressed reservations about privatizing state assets in a low-oil-price era when valuations are likely to be well below what they would have been when oil topped US$100 a barrel. Others fear privatization could encourage crony capitalism, with state-owned champions sold off on the cheap to large investors. Prince Mohammed has quashed such concerns, saying that the IPOs would help distribute wealth and that state companies had over the past decade been listed with cheap valuations to allow Saudis to buy shares, which may rise after the listing. In this way, the listings aren't limited to only the wealthiest citizens—more people can take part in them.

Of course, there are some problems in the Saudi economy that the Vision alone may not be able to solve. For example, the Minister of Labor had to get involved after people who were working on the King Abdulaziz Airport expansion project in Jeddah were facing problems getting paid. Workers burned a number of company buses in protest over nonpayment of wages. In an effort to control the fiscal deficit, government ministries have been ordered to cut at least 5% of spending, and delays in payments to firms have created cash-flow problems for the companies as well as worker disturbances, in a country where demonstrations are not allowed. The issue of foreign workers is an important one as well, since foreign workers in Saudi Arabia are estimated to represent between 20% to 30% of the entire population, with Indians and Pakistanis the largest foreign groups. However, part of the Vision is a "Green Card" system, which aims to address issues with expatriate workers—so the government is certainly aware of these problems and trying to solve at least some of them.

Another article I read outlined another problem: the myriad lawsuits and litigation between property owners and their tenants. The headline read: "Ninety percent of leases illegal," which seemed shocking to me. The government plans to establish an electronic system which will track all property leases in order to identify rent defaulters and have a unified single contract and electronic payment system. This is only part of a reform initiative to make dramatic changes in land ownership, particularly in the major cities where large tracts of land were left idle while there was an on-going housing shortage. Wealthy businessmen and the many members of the royal families hold land and haven't developed it since there hasn't been a penalty for keeping it undeveloped. But, now there are plans to introduce a property tax to encourage development of the vacant land, which hopefully would result in more housing for more of the population.

Change does seem to be coming in Saudi Arabia, a country with some interesting paradoxes. For example, at the conference I attended, I noticed there were a number of Saudi women who did not have their head covered and wore Western-style dress, but the biggest surprise to me as a Westerner came when I visited the mall attached to the hotel where I was staying; it had a lingerie shop for women with a sales staff comprised only of men. Gradually though, it does appear more women's rights are being granted. In 2011, King Abdullah announced that Saudi women would gain the right to vote and to be candidates in municipal elections, provided that a male guardian granted permission, and by 2015, women were finally allowed to vote.

Coming from the airport in Riyadh I saw a huge tract of land with many impressive buildings which I learned was a new university for women. Despite moves toward some educational reforms, strict religious tradition remains a dominant part of daily life in Saudi Arabia, particularly in the education system. The issue of extremism also cannot be denied, but of course this subject is a very complex one and requires more study and understanding.

The next time I get to Saudi Arabia I hope I have the opportunity to get out of the capital city and visit more of the other areas, not only to learn more about how people in different walks of life live, but also to learn about sectors and industries outside of energy. Of interest to me personally are the mineral resources, particularly gemstones. Saudi Arabia has volcanoes that apparently have thrown up peridots, my birthstone.

It's our view that Saudi Arabia holds many interesting opportunities for investors, and if its expansive vision proves successful, it could cause economic growth to expand in many different directions—with or without high-flying oil prices.

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1. Source: Saudi Stock Exchange performance report, first quarter 2016.

2. Source: Bloomberg, as of December 2015. There is no assurance any estimate or forecast will be realized.