جدوى للإستثمار
Jadwa Investment

August 2017

Q2 2017 Budget Statement

The fiscal deficit continues to show yearly declines

- The latest quarterly budget performance report by the Ministry of Finance (MoF) showed a continued improvement in Saudi Arabia's fiscal position.

- Due to an increase in government revenue, by 6 percent, and a drop in expenses by 1 percent, year-on-year, the fiscal deficit declined to SR46.5 billion in Q2 2017, compared to SR58 billion a year ago.

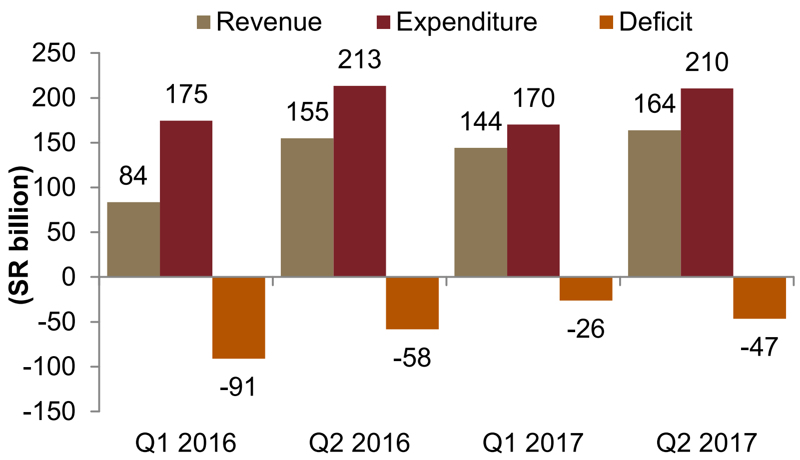
- Continued yearly improvements in oil revenue helped lift overall government revenue in Q2 2017. At the same time, total non-oil revenue decreased by 17 percent year-on-year, with all but one segment -'Taxes on Income', showing yearly declines.

- Total government expenses dropped by 1 percent year-on-year in Q2 2017. This was largely a result of a drop in capital expenditure, which fell by 12 percent year-on-year, whereas current expenditure rose by 1 percent year-on-year.

- Looking ahead, we do expect to see a significant ramp up in government capital spending in H2 2017, similar to the pattern observed in H2 2016. That said, the risk of lower than forecasted oil prices could result in budgeted capital spending coming in lower than our forecasted SR260 billion, for 2017 as a whole.

- We also expect to see year-on-year improvements in non-oil revenue following the introduction of an excise tax on harmful products, higher expat levies and dependent fees, and a rise in seasonal investment income.

Figure 1: Budgetary performance in Q2 2017



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Revenues:

Government revenue totaled SR164 billion in Q2 2017, up 6 percent year-on-year...

...with the vast majority of this rise due to higher oil revenue as a result of higher yearly oil prices, but not higher export volumes.

Table 1: Government Revenue (SR million)

Revenues	Q2 2016	Q2 2017	Change (%)
Oil revenues	78,949	100,990	28
Non-oil revenues, of which;	75,971	62,916	-17
-Taxes on income, profits and capital gains	5,556	7,201	30
-Taxes on goods and services (including petroleum product charges and harmful product tax)	8,008	8,084	1
-Taxes on trade and transactions (customs duties)	8,804	4,941	-44
-Other Taxes (including Zakat)	11,731	10,596	-10
-Other revenues (including returns from SAMA and PIF)	41,872	32,094	-23
Total	**154,920**	**163,906**	**6**

Saudi government **revenue** totaled SR164 billion in Q2 2017**,** up 6 percent year-on-year (Table 1). The vast majority of this rise was due to improvements in **oil revenue** as a result of higher yearly oil prices (Figure 2). Despite higher oil prices, the Kingdom's strict adherence to OPEC agreement cuts resulted in lower oil and refined products exports, compared to a year ago. Jadwa estimates that the Saudi export price of crude and refined products increased by 18 percent year-on-year, to $51 per barrel (pb) in Q2 2017. At the same time, due to lower output in accordance with the OPEC agreement, provisional Q2 2017 data shows that Saudi oil and refined products exports dropped by around 6 percent, or close to 500 thousand barrels per day (tbpd) in Q2 2017 year-on-year. Accordingly, the Kingdom saw oil export revenue rise by 11 percent, or SR13 billion, year-on-year (Figure 3). Looking ahead, we expect oil export revenue to show only mild improvements on a yearly basis in Q3 2017. Whilst Brent oil prices are currently above $50 pb, compared to around $45 pb during the same period last year, continued adherence to OPEC cuts by the Kingdom will result in lower volumes of oil and refined product exports, ensuring modest rises in oil revenue.

Figure 2: Government revenue in Q2 2017 improved due to higher oil revenue...

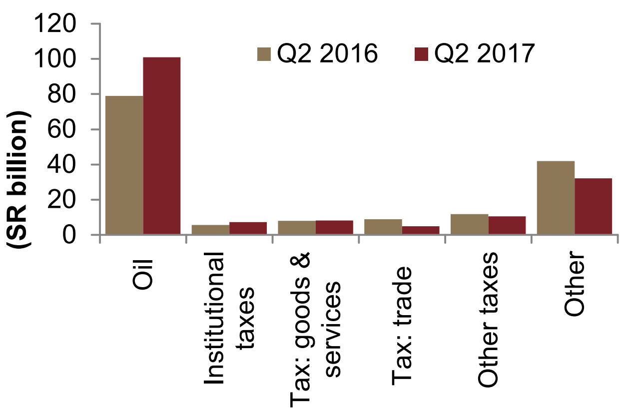
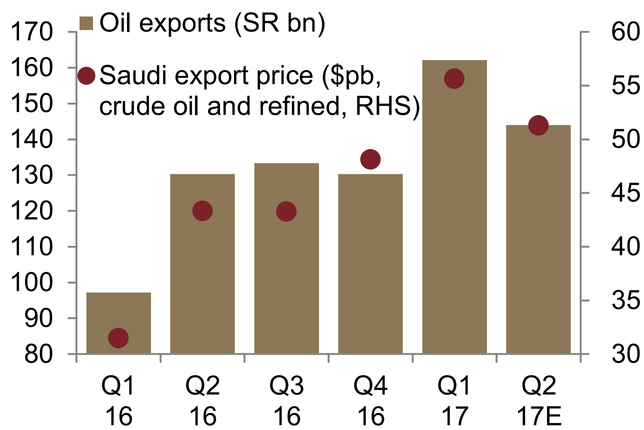


Figure 3: ...as oil prices increased but export volumes declined



Non-oil revenue decreased by 17 percent year-on-year in Q2 2017…

...with all but one segment -'Taxes on income etc.'-showing yearly decreases.

'Taxes on Trade and Transactions' were down by a sizable 44 percent year-on-year.

Total **non-oil revenue in** Q2 2017 decreased by 17 percent year-on-year, with all but one segment -'Taxes on income etc.'-showing yearly decreases (Figure 4). 'Taxes on income etc.' were up by 30 percent year-on-year in Q2 2017. Since there were no specific changes in tax to justify the sizable yearly increase, we believe a part of this rise could be due to a result of a general improvement in the collection process on behalf of government. Specifically, in the first quarter of 2016 the Saudi General Authority for Zakat and Tax (GAZT), the organization responsible for the collection of such taxes, introduced a new online filing system, but some technical issues pushed the collection of the revenue back to later quarters. Meanwhile, 'Taxes on Trade and Transactions' were down by a sizable 44 percent year-on-year. The decline likely reflects not only a general reduction in the level of imports during Q2 2017, but also an adjustment in the importation of products with higher customs tax, following an expiration of duties on 193 products, at the beginning of the year (Figure 5).

A one-off item related to the privatization of assets boosted Q2 2016 'Other Revenues'…

...and led to sharp decline in this segment in Q2 2017 year-on-year.

Looking ahead, the seasonal nature of dividends from TASI listed companies means that Q3 2017 'Other Revenues' is likely to be higher on a quarter-on-quarter basis.

According to the MoF, a one-off item related to the privatization of assets, the details of which were not specified, boosted last year's second quarter 'Other Revenue'. As a result, a sharp decline in this segment, by 23 percent, was recorded in Q2 2017 year-on-year. Looking ahead, the seasonal nature of dividends from TASI listed companies means that Q3 2017 'Other Revenue' is likely to be higher on a quarter-on-quarter basis. For example, most companies within the two largest Tadawul All Share Index (TASI) sectors, petrochemicals and banking, pay dividends on a semi-annual basis. However, due to lags in financial results reporting, these payments are likely show up as investment income in both the first and third quarters of the year. That said, as a result of drop in FX reserves by $37 billion in foreign securities since mid-year 2017, SAMA's investment returns are likely to be lower and, as a result, limit the extent of yearly rises in 'Other Revenue'.

<u>Expenditures:</u>

Total government expenses dropped by 1 percent year-on-year in Q2 2017, to a total of SR210 billion…

Total government expenses dropped by 1 percent year-on-year in Q2 2017, to a total of SR210 billion (Table 2 & Figure 6). Current expenditure, the non-growth element of government spending, was up 1 percent year-on-year. The largest contributor to current expenses, 'Compensation of Employees' was flat year-on-year in Q2 2017, following a year-on-year reduction of 5 percent in the previous quarter. The rise on a quarter-on-quarter basis was most likely due to

Figure 4: Year-on-year change in Q2 2017 non-oil revenues

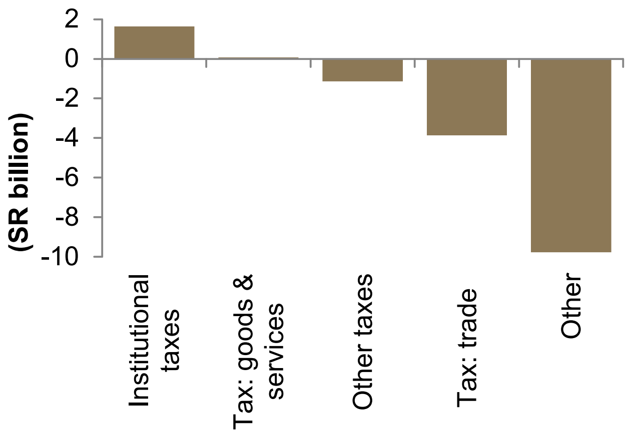
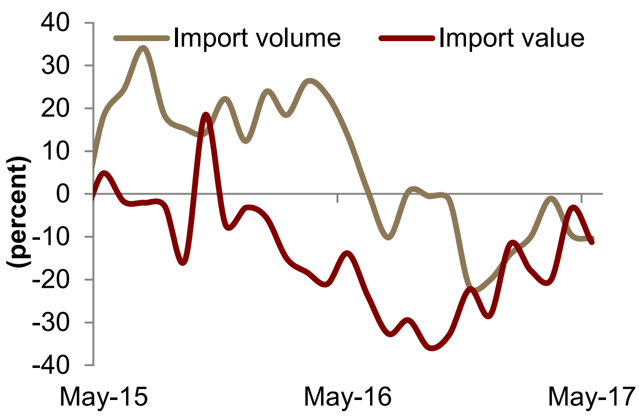


Figure 5: Year-on-year change in import volumes and values



...with the largest contributor to government expenses, 'Compensation of Employees' being flat year-on-year in Q2 2017.

allowances of public sectors workers being reinstated following a Royal decree in April 2017, although the previously installed wage freeze was kept in place. The 'Compensation of Employees' segment represents the most rigid aspect of government expenditure and is therefore likely to remain at around current levels in the forthcoming quarters.

Table 2: Government Expenses (SR million)

Expenses	Q2 2016	Q2 2017	Change (%)
Compensation of Employees	103,247	102,788	0
Goods & Services	44,929	27,239	-39
Financing Expenses	1,238	3,011	143
Subsidies	2,804	1,135	-60
Grants	300	640	113
Social Benefits	11,331	16,587	46
Other Expenses	11,476	25,772	125
Non-Financial Assets (Capital)	37,972	33,251	-12
Total	**213,297**	**210,423**	**-1**

Lower expenditures on 'Good and Services' reflects a general cut back in government procurements and projects...

...in line with cost rationalizing and operational efficiency targets set out in the National Transformation Plan (NTP).

Lower expenditures on 'Goods and Services' reflects a general cut back in government procurements and projects, in tandem with cost rationalizing and operational efficiency targets set out in the National Transformation Plan (NTP) 2020 and Saudi Vision 2030. This point was reiterated by the Minister of Finance earlier this year, stating that the Bureau of Capital and Operational Spending Rationalization (BCOSR) had succeeded in saving up to SR17 billion for the whole of 2017, after reviewing state projects and other expenditures. Such savings and rationalizations are also likely to account for the reduction in 'Subsidies' segment in expenditures (Table 2). Generally speaking, it is important to note that the deflationary trend seen in the Kingdom since the start of the year also contributed to reducing some costs outlined above.

In Q2 2017, 'Financing expenses' continued to exhibit year-on-year rises, in-line with rising government debt.

'Financing Expenses' continued to exhibit year-on-year rises, in-line with rising government debt. This segment was up SR1.7 billion, or 143 percent, year-on-year in Q2 2017. Public debt totaled SR142 billion at the beginning of 2016, but had risen to SR341 billion at the end of Q2 2017, with only a small repayment of debt being made

Figure 6: Year-on-year change in Q2 2017 current expenditure

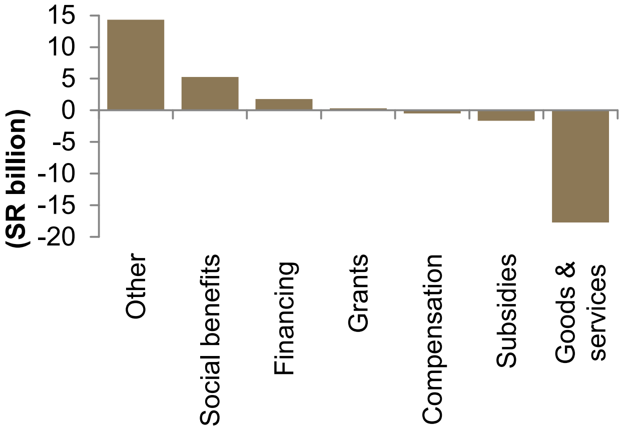
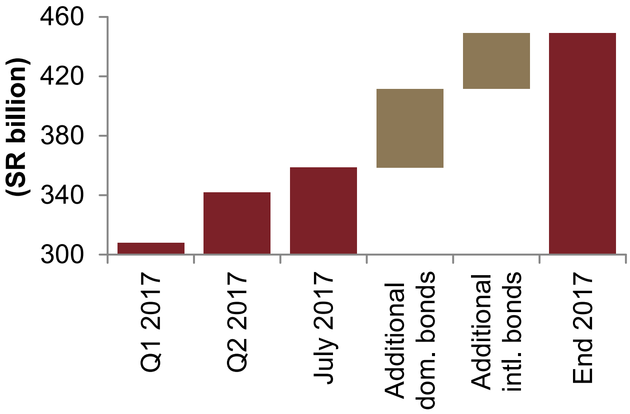


Figure 7: Total government debt could total SR450 billion at the end of 2017



In July 2017, the government announced the issuance of domestic sukuk program, with a total of SR17 billion being raised.

during the quarter. More recently, in July 2017, the government announced the issuance of a domestic sukuk program, with a total of SR17 billion being raised. Adding this to the Q2 2017 total puts current government debt at SR358 billion. Previous comments from the Ministry of Economy and Planning have stated that the government may return to international bond markets for around $10 billion (SR37 billion) in Q4 2017, in addition to raising SR70 billion through domestic bonds during the year (SR17 billion of which has already been issued). Taking all this together, and assuming no sizable repayments, government debt is expected to total SR450 billion by the end of 2017, equal to 17 percent of GDP (Figure 7).

'Social benefits' were up by 46 percent year-on-year…

...whilst 'Other Expenses' rose by 125 percent.

The remaining segments of current expenditure include 'Social Benefits' and 'Other expenses'. Although 'Social Benefits' saw a steep rise in Q2 2017, by 46 percent year-on-year, looking at half year data shows that the rise was more muted, at 21 percent year-on-year. 'Other Expenses', on the other hand, showed a significant rise of 125 percent or SR14.2 billion year-on-year in Q2 2017. This trend was also seen on a half year basis, with a 49 percent or SR15 billion increase year-on-year. It is not quite clear what caused a sharp increase in this segment during Q2 2017.

Capital spending declined by 12 percent year-on-year, to SR33 billion, in Q2 2017…

...lower quarter-on-quarter oil prices seemed to have limited the extent of government capital spending during Q2 2017.

The capital spending side of expenses, or 'Non-Financial Assets (Capital)', decreased by 12 percent year-on-year, to SR33 billion, in Q2 2017. Lower quarter-on-quarter oil prices and marginally higher current spending seemed to have limited the extent of government capital spending during the quarter. We estimate budgeted capital expenditure at SR260 billion for 2017 as a whole, but our estimate is based on Brent oil price of $55 pb for the year. With year-to-date Brent oil prices currently averaging $51 pb, there is a real downside risk to our capital expenditure forecast.

There was a significant ramp up capital spending in H2 2016...

...and we expect to see a similar pattern in capital spending during H2 2017.

Government capital expenditure totaled SR62 billion at the end of H1 2017, up only marginally by 1 percent year-on-year. According to our calculations, total 2016 capital expenditure equaled SR165 billion, meaning almost 60 percent of capital expenditure was spent during H2 2016. No doubt, higher and more stable oil prices in H2 2016 helped spur the acceleration in capital spending, but the nature of government payments, with certain projects being paid on completion, also helped boost capital expenditure. Taking this into account, we would therefore expect to see a significant ramp up in government capital spending in H2 2017 (Figure 8), barring a major decline in oil prices below current levels.

Deficit:

The fiscal deficit dropped by 20 percent year-on-year, to SR46.5 billion, in Q2 2017...

...SR15 billion of the deficit was financed from FX reserves, and the remainder through an international sukuk.

Due to an increase in government revenues, by 6 percent and a drop in expenses by 1 percent year-on-year, the fiscal deficit improved to SR46.5 billion in Q2 2017, compared to SR58 billion a year ago. The combined deficit for H1 2017 stood at SR 72.7 billion, which, on a pro-rata basis, comes in significantly lower than the government's projected 2017 deficit of SR198 billion, as outlined in the fiscal budget. Moreover, the latest budget statement shows that SR15 billion of Q2 2017 deficit was financed from FX reserves, with the remainder through a SR33.7 billion international sukuk. According to SAMA data, government FX reserves declined by SR30 billion during Q2 2017. This implies the remaining SR15 billion in FX reserves were used to pay a balance of payments deficit. Latest available data shows that the Kingdom is likely to have posted a positive trade balance during Q2 2017 and, as a result, the remainder of the FX reserves were most likely used to pay for a deficit in the invisible account.

Outlook:

There is likely to be less dramatic yearly upswings in oil revenue going forward...

The Q2 2017 quarterly budget is an improvement over last year, but as with Q1 2017, this improvement is primarily a result of rises in **oil revenue**. Using provisional data for H1 2017, Jadwa estimates that the Kingdom's total oil export revenue amounted to SR306 billion in H1 2017. Of this, crude oil export revenues made up SR213 billion ($57 billion), whereas refined oil products export revenues contributed SR92 billion ($24 billion) (Figure 9). According to the budget statement, government oil revenue totaled SR212 billion in H1 2017. Meanwhile, as detailed in 2017 fiscal budget, the government is budgeting for SR480 billion in oil revenues for 2017 as a whole. By taking the H1 2017 government oil revenue figure, at SR212 billion and deducting half the budgeted oil revenue figure for 2017, points to a short-fall of SR28 billion in government oil revenue in H1 2017.

...but non-oil revenue should improve as expat levies, excise tax and higher investment income rises in Q3 2017.

Looking ahead, the strict compliance by Saudi Arabia to OPEC cuts, with lower oil exports, is likely to result in less dramatic yearly upswings, especially since oil revenue improved in H2 2016. That said, in the following quarters we do expect to see year-on-year improvements in **non-oil revenue.** The introduction of an excise tax on harmful products, higher expat levies and dependent fees, both of which came into effect in July 2017, plus a rise in seasonal investment income, should all help raise non-oil revenues in Q3 2017.

However, the additional revenue from the land tax is not likely to be seen until 2018, since landowners are required to pay the fees within one year from being issued the invoice.

Based on data from the Ministry of Interior's National Information Center, there are currently 2.2 million registered dependents in the Kingdom and, with a fee of SR100 per dependent, the expected rise in revenue should therefore total SR660 million in Q3 2017. In reality, receipts from such fees are going to be less than the above figure, since many dependents are likely to repatriate prior to payment of the fee. Separately, at the end of March 2017, the government announced the commencement of a tax which requires owners of undeveloped land to pay a fee of 2.5 percent of the land's value. The Ministry of Housing stated that the tax could raise anywhere between SR1-2 billion per annum in additional revenue. However, the rise in revenue from this tax is not likely to be seen until 2018, since landowners will be given one year to settle their tax dues after being issued with an invoice.

The government was expected to save an additional SR30 billion during the year as a consequence of electricity price hikes, but this was delayed…

On the expenditure side, with the government delaying the linking of household electricity prices to a higher reference price, as was expected in mid-2017, the rise in expenditures related to the start of

Figure 8: Depending on oil prices, capital spending should see sizable rise in H2 2017

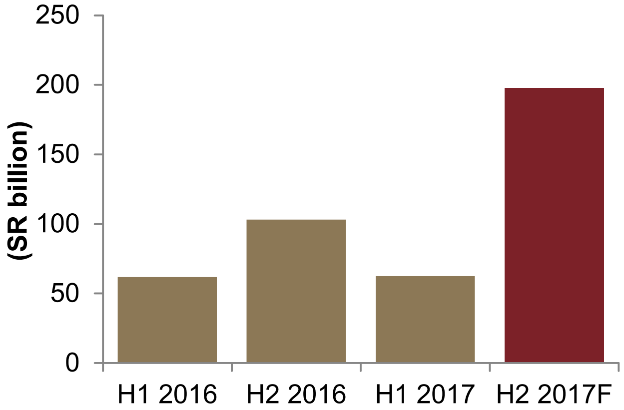
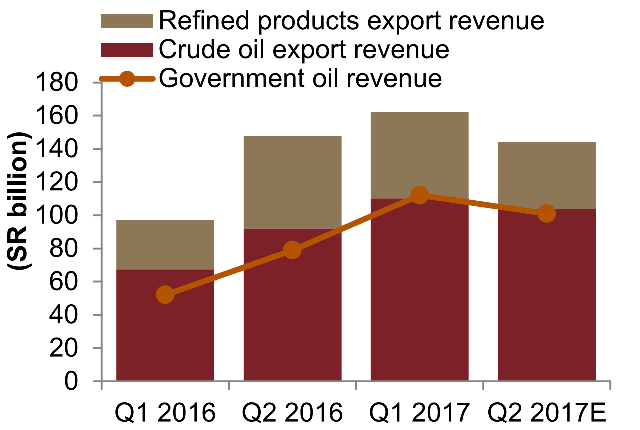


Figure 9: The Kingdom's crude oil and refined products export revenue and government revenue



...but capital expenditure should see sizable rises in the second half of year, much like 2016.

the "Household Allowance Program", will not be incurred in 2017. That said, the government was also expecting to save an additional SR30 billion during the year as a consequence of the same price hikes. As a result, no major additional savings in expenditure are expected going forward. Nevertheless, separately, savings associated with the BCOSR will continue to be seen during the whole of 2017. Lastly, as highlighted above, we do expect to see a significant ramp up in government capital spending in H2 2017 (Figure 8), similar to the pattern observed in H2 2016. That said, the risk of lower than forecasted oil prices could result in budgeted capital spending coming in lower than our forecasted SR260 billion for 2017 as a whole.