

Confidence levels decline... to 89.2 from 96.4

Saudi Arabia's Business Confidence Q1 – 2009

- ▶ **Majority of businesses expect overall business and revenue growth to plateau in the next two quarters**
- ▶ **Businesses are expecting bank lending to weaken further. 32% of survey respondents expect bank lending to be “not so severe” and 27% expect bank facilities to be “severe”**
- ▶ **Businesses are on a hiring freeze**
- ▶ **Concern about the local stock market performance leading to substantial negative wealth effects has taken the Confidence Index below 90 for the first time**
- ▶ **Most respondents expect real estate prices to continue falling**

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Businesses braced for a further slowdown

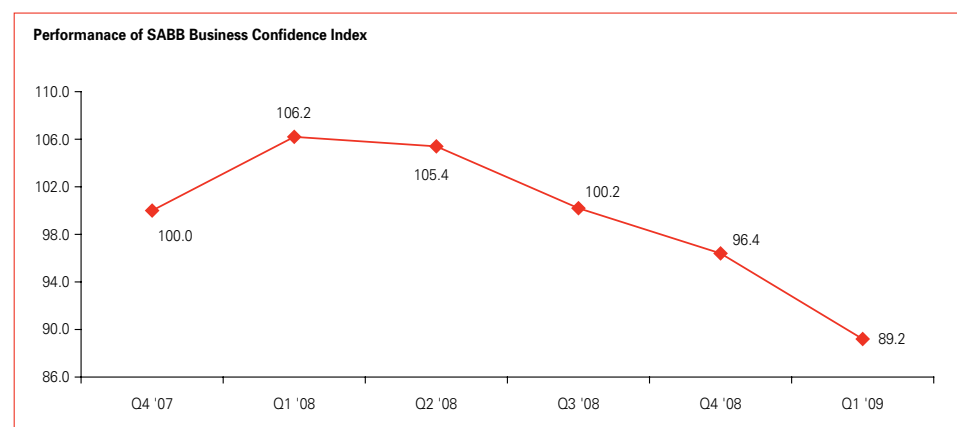
Saudi Arabia's economy is not isolated from the global economic recession and neither are businesses in the Kingdom. The expected downturn in the economy is clearly reflected in our Q1 survey, revealing that business confidence in Saudi Arabia is weakening further (see “What we think” section). Against the backdrop of precipitously worsening global economic data, it would appear hard not to expect Saudi businesses to anticipate worsening conditions. Some 42% of businesses expect growth in their organisation, compared to 54% in our previous survey. The survey took place after the announcement of the budget in late December '08 which should have provided a cushion of hope.

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Disclaimer

These Notes should be read in conjunction with the concluding Disclosure appendix and Disclaimer, which form part of them.



From our survey of 765 companies (previously 623) across diverse industry sectors:

- ▶ As mentioned above, 42% of respondents expect business growth in Q2 and Q3 '09, but it should be noted that this is down from the 89% we reported in Q3 '08
- ▶ Only 24% report a rise in production capacity (compared to 53% in Q4 '08), the change does mark a noticeable decline which has been ongoing since H2 '08. Going forward, 18% of respondents do expect production capacity to fall in Q2 and Q3 '09 and 58% expect it will remain the same

Overall, the business environment is clearly showing signs of a slowdown with 57% anticipating that business growth to remain the same and 43% expecting it to be weaker. Nobody is expecting business growth to get significantly weaker, which is indicative of things not getting worse in the future.

The impact of the global recession seems to worry businesses in the Kingdom. Only 7% of those surveyed do not expect the Saudi economy to be affected, while 23% expect that it will indeed be affected and another 66% that it might.

Growth

As the global economy and particularly the prospects of a 2009 recovery in the US and/or Eurozone appear close to nil, the Saudi economy is not cocooned from the impact of the global crisis. As such, the SABB Index figure continues to decline.

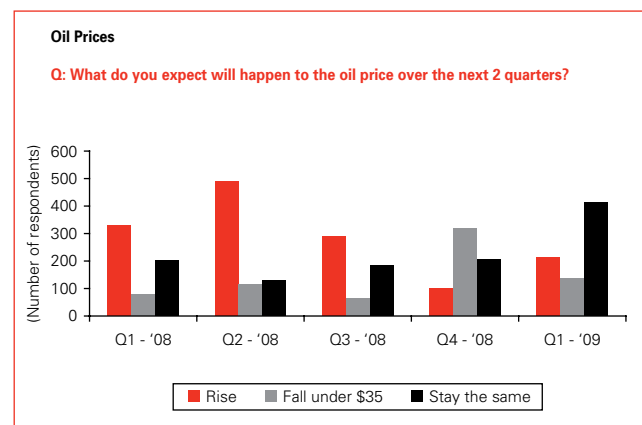
Our latest findings reveal that business confidence is down to 89.2 (from 96.4) – a 7.47% decline, compared to a 3.8% in Q4 '08. The survey attributes this to a number of factors, including:



- The slowdown in growth for businesses continue expect
- The further fall in oil prices in Q1 '09
- The anemic performance of the local stock market, coupled with the worsening global economic environment

Oil prices are falling and confidence follows suit

When businesses were surveyed this time, oil prices were in the mid to high \$30s. Majority of those surveyed (54%) expect prices to stay the same,

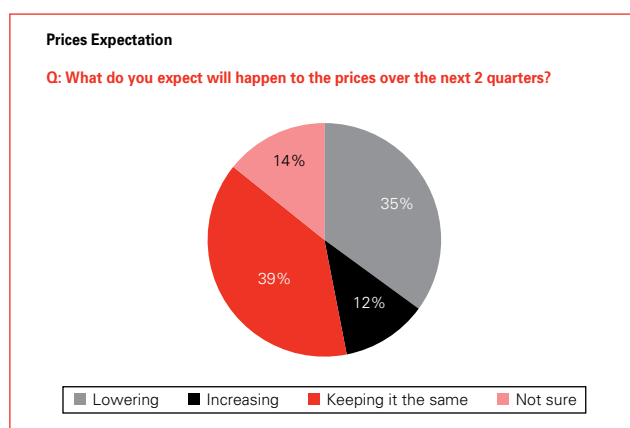


only 28% expect prices to rise and 18% expect oil prices to fall under \$35. It seems that the market is pessimistic about oil prices which impinge on economic expectations in the Kingdom.

Falling price expectations

Market expects prices to fall. We noted in our previous confidence report that there are mixed signals about business vulnerability in certain sectors (autos) and a slowdown in others (consumer electronics). We were not able to ascertain if seasonal factors could account for the slow pace in demand or there were other structural factors that were unfolding. What does demand have to do with prices?

We decided to investigate the anecdotal evidence we had accumulated over the past few weeks that demand for several consumer goods was declining due the market's expectation that prices will fall. Hence, we first asked if businesses are considering lowering prices over the next two quarters. Most (39%) responded that prices will be kept the same, followed by 35% who are considering lowering prices. A minority of 14% are not sure, while 12% are considering increasing prices.



We then wanted to dig a bit further and see what businesses expect in car prices. Not only how this impacts on fleet sales to the private sector, but also how one segment of society perceives the behaviour of prices. 70% of the respondents expect car prices to fall in the next two quarters and only 25% expect to stay the same.

The expectation of lower prices on several goods, including autos, is reflected on the general expectation of falling inflation. Most of the respondents (69%) expect inflation to fall over the next two quarters which we perceive as good for business, and positive for the final tally in the Index.

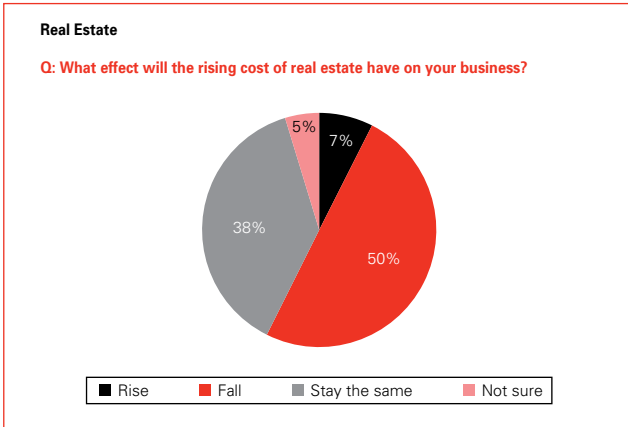
Saudi Riyal: Same story

Not much excitement on the currency front for speculators, but good news for business predictability. It's no surprise that most businesses find the currency issue far less worrying than it was prior to the summer. With 88% of respondents not expecting the Riyal to be revalued, and only 5% of respondents expecting a change in the next two quarters, we ascertain that the revaluation debate is of little concern to the business community.

We also felt it would be pertinent to ask again how businesses view the prospect of a GCC currency union by 2012. Most of the respondents (77%) say they do not expect the union to take place by that date, against a slightly lower response (73%) in the previous Index report.

Real estate: Good news

There is some good news. The survey shows that rising real estate prices seem not to pose a worry for companies across the Kingdom. In the survey,

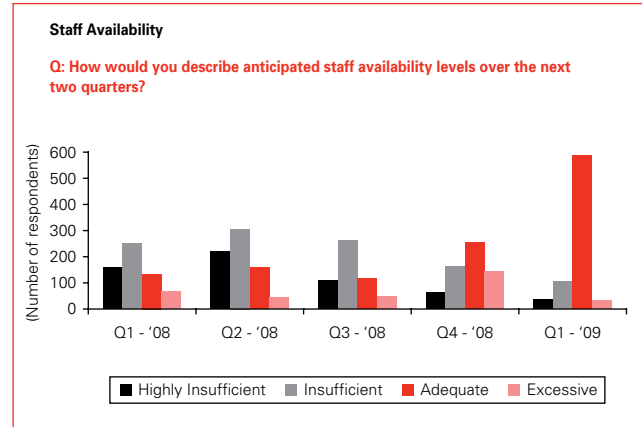


we have witnessed a substantial shift in expectations as only 7% of respondents (46% in Q4, 68% in Q3) say they anticipate the cost of real estate to appreciate, resulting in a positive impact on their business in the next two quarters. Some 50% of companies expect real estate prices will fall in the next two quarters against 31% that was noted in Q4. And 38% of respondents expect real estate prices to remain the same over the next two quarters.

The above indications could signal a structural shift in the real estate market, which could translate into lower business rents and an overall correction in real estate prices. We also take the view that movements in the regional real estate markets will impact on Saudi Arabia and bring down property prices in 2009.

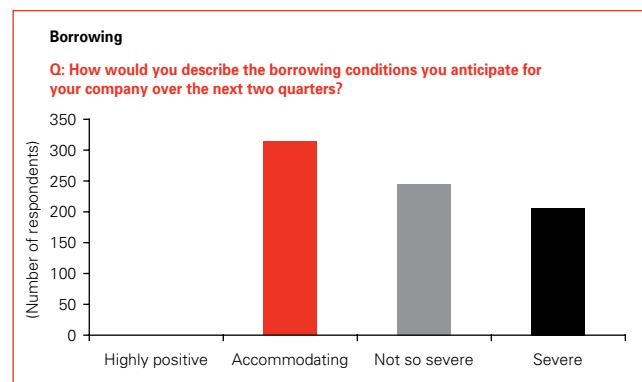
Labour market: Good news for employers

The good news is for employers not employees. The availability of human resources is an added concern for businesses, as labour supply constraints can limit expansion in the non-oil private sector. It's evident that the labour market is no longer facing a dearth of skilled workforce. Among our survey respondents,



only 14% (26% in Q4 and 49% in Q3) report that their organisations do not have all the required staff and just 5% (10% in Q4 and 20% in Q3) expect to be “very insufficiently” staffed in the next few quarters. Overall, employers seem to be improving on the labour supply front, as 77% (41% in Q4 and 22% in Q3) regard their companies as adequately staffed.

We also decided to ask a more sensitive question about employment as we tried to gauge labour market hiring trends. In part, it serves to reinforce or discount the responses we get about our aforementioned question on labour supply in the economy. As the slowdown in the economy is unfolding we are not surprised with 74% of the respondents who expect over the next two quarters to institute a hiring freeze.



26% of the businesses we surveyed expect to hire over the next two quarters.

Bank lending and interest rates

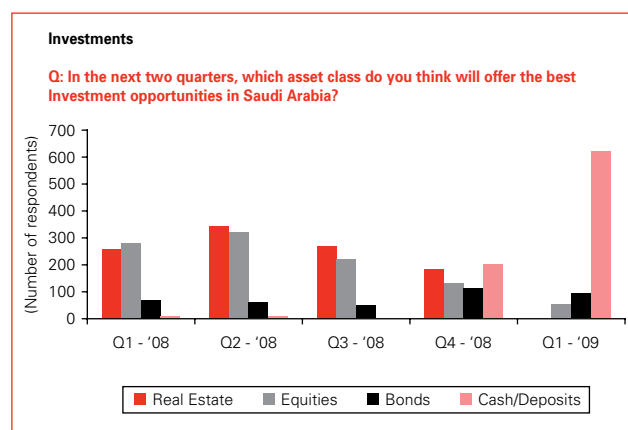
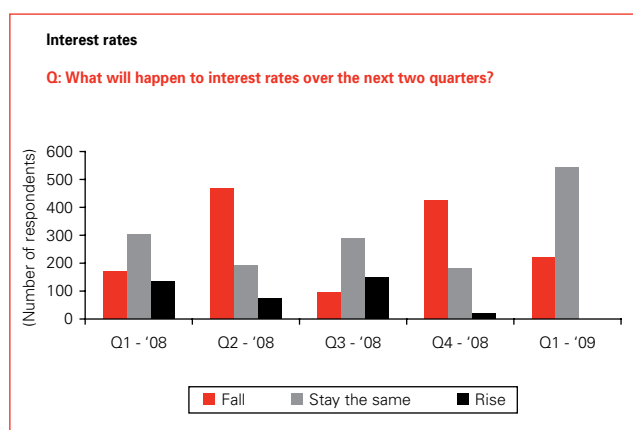
Lending appetite could be winding down as banks become liquid. We notice that businesses continue to be less optimistic about the lending attitude of banks in the Kingdom. 41% of respondents expect bank lending to be “accommodating” this quarter (up from 33% in Q4 and 38% in Q3), with no-one responding “highly positive” which is the exact similar response to the one we got in Q4. Some 32% of those surveyed responded as “not so severe” which is a big difference from the 25% noted in the previous quarter. However, the big change is our last question which brings light of hope. Some 27% believes that bank lending would be severe, unlike 42% who asserted in the previous survey that lending conditions are severe. It seems that the government’s measures are positively received from the businesses we surveyed.

SAMA’s five-time reduction of interest rates since October has led to interbank rates being slashed by more than two-thirds. Hence, expectations amongst

businesses have changed. In contrast to 29% in Q3, 71% of respondents anticipate that the interest rate will stay the same, while none expect them to rise and 29% anticipate a fall of between 25 and 100 basis points.

Investment opportunities: Show me where

There seems to be a natural instinct for quality and safety in Saudi Arabia. As we noted in our previous Index report, cash and deposits seem to be the preferred investment option for businesses at the moment, while real estate and local equities are not in favour. Some 81% of respondents show a preference for cash and deposits against 32% in Q4, only 12% prefer bonds and just 7% have a preference for local equities (against 50% in Q3). It is no surprise that preferences have changed as the global economic landscape continues to worsen and local equities are ailing.



What we think: As the global economy has entered its deepest recession since the early 1930s, we would find it surprising if business confidence remained unscathed in Saudi Arabia. Market psychology in an economy is often as important as market demand and we think that in part, the slowdown witnessed in the market place is due to declining confidence.

Saudi businesses and their owners are impacted by global events. We think that businesses are bracing for a slowdown in 2009, which is not unfounded, but the causes are not uniquely local. Businesses and particularly their owners are impacted in one important way affecting confidence in the economy: Unlike any other economic slump the world has faced, this one has substantially impacted on the net worth of Saudi businessmen. The uniqueness is that there is nowhere to hide as local and regional markets have been severely battered and international equities are at best anemic.

The 2006 stock market fall in Saudi Arabia impacted mainly on small retail investors, whereas the 2008 plunge affected the large player. These investors were using plentiful local and international credit in anticipation of high returns. Even when the market went through an initial fall in early 2008, many large businessmen leveraged themselves in anticipation of euphoric returns later in the year. The drop in the stock market in 2008 has witnessed a SR 1,02 tn being wiped off values, which has acutely affected the net worth of large businessmen. This negative wealth effect made a large segment of the business community become much more careful. Hence, many businesses are putting off expansion plans as uncertainty puts downward pressure on confidence.

However, psychology is not the only determining factor for confidence in the economy. Demand (consumer or otherwise) is another component that builds on the level of confidence. We continue to think that demand is declining. Consumers are not as exuberant as in H1 '08 and are showing signs of becoming price-thrifty. We think that many consumers expect prices to fall in the domestic market, especially for big-ticket items. Automobiles is one of them as consumers expect prices to fall due to falling auto sales abroad. Both US autos and Japanese car agents (which form the bulk of the market) have noticed a decrease in sales (both December 08-January 09 as well as y-o-y basis), with only one exception currently being Toyota Saudi Arabia. The market is not always right though. Unit costs for autos will increase, not decrease, as margins will decline due to a fall in the economies of scale advantage following an overall fall in total production. In fact, many automobile manufacturers are instituting price increases. The appreciation in the Japanese Yen is also negatively impinging on the final import cost. Saudi auto agents could also face more competition from second-hand and new car imports by non-official agents, as per WTO agreement. Imports of used cars or new cars priced at below local market prices could force agents to liquidate inventories and institute a price war, though we think that this is not likely but not completely unimaginable.

Consumers seem to also be less willing to spend as much on consumer electronics as there is a perception, we think, that prices will also fall. Here we might see brand substitution later in the year as certain brands (especially Korean-manufactured

products) will take advantage of the weaker currency and others (Chinese-made) gain market share due to competitive pricing. In this environment, we take the view that consumers in Saudi Arabia will slow down their purchases at least until H1 '09. We need not forget that consumers also spend on impulse and that at the moment the mood is one of circumspection. But we don't think that consumer demand is being destroyed, nothing close to what the US, Eurozone or Japan is witnessing currently.

Lower oil prices are taking their toll on confidence. Last time we conducted our survey, oil prices were ranging between \$48 and \$55 as the global economy was bracing for a slowdown in oil demand. By December WTI closed at \$31 and many expected that the worst was yet to come in terms of commodity prices. World oil demand is contracting more than expected this year. Recently, OPEC said global demand would fall by 580,000 barrels per day in 2009, whilst its previous forecast was for demand to contract 180,000. OPEC's predictions of falling demand are less pessimistic than that of the IEA (International Energy Agency) which also recently said that consumption in 2009 would fall by 980,000 barrels per day. The OPEC cuts have brought some results but the only tool available to avert a further drop in oil prices will be to rein in more production and adhere to quota discipline which could be out of character for some countries. However, we maintain our thinking that oil prices would be exaggerated on the way down, just as they were on the way up during the summer of 2008. High volatility in oil prices will be maintained but we also hold to our forecast of average WTI of \$44 per barrel for 2009.

As mentioned, we think that inflation will come down more substantially than the consensus view. Given the 2008 final inflation data and also January 2009 inflation data (7.9%) we forecast average inflation of 5.8% for 2009. We think that inflation will begin to decline more aggressively in Q2 which could have a greater impact on confidence levels, both with businesses and consumers. However, we don't think that prices will enter a huge deflationary downward spiral, but that they will stay above historical trends. Real estate prices will come further down in the coming months, especially commercial office space due to an oversupply and lower demand as the private sector slows down.

We think that confidence in the Saudi economy would have dipped more aggressively had it not been for an expansionary 2009 budget that is beginning to be felt as increased government spending. This spending has a delayed effect in the real economy, but we think it will become more widely felt in the months to come. We think that the government has already approved SR 8 bn above and beyond the announced budget. And we are still at the onset of 2009. Also, we note that in the month of December alone SR 14.4 bn was deposited by SAMA (an increase of almost 1000%) on behalf of government organisations (such as GOSI, pension funds, SIDF, SDF, REDF and others) with the local banks. As of December '08 besides the above mentioned government organisations other government entities have not yet become net depositors in the local banking system.

The spending that the government is carrying out, however, is unique in many ways, as it involves no deficit financing. In contrast, the US and many Eurozone economies, fiscal stimuli are carried out through debt issuance. Saudi Arabia has very little debt

and its spending is based on deploying surplus funds that have been piled up in the “good days” of the third oil boom. Based on our discussions with Saudi businesses there is a “wait and see” attitude to the actions the government will take to boost confidence in the economy. It is, however, easy to criticise the government when in fact the private sector also needs to take steps to become more capital efficient. The Saudi government will not go bust as its finances are better than most OECD countries, although some Saudi companies could face more challenging times ahead. But the private sector needs to be transparent so as to avoid rumour becoming fact by causing a further fall in confidence in the market place.

With the above in mind, we think that the debate about banks’ liquidity should be refocused. Liquidity in the strict sense for a bank is its ability to meet its financial obligations as they come due. We think that banks are liquid in that sense and far more liquid than many regional banking systems. While banks can’t lend ad infinitum, we believe that there are three interrelated trends unfolding in the banking system:

- ▶ Banks are more risk averse as they need to take stock of the high and often exuberant lending growth they have carried out over the past year and a half
- ▶ Banks want to observe the private sector’s ability to meet its obligations (in some instances we believe that banks are more stringent than they need be, though this is by no means certain)
- ▶ Private-sector borrowing appetite is decreasing as the private sector is gauging the economic climate and is not isolated from the vagaries of the global economic crisis

We are not of the opinion that banks are failing to lend because banks have “run out of money”. This is the false assumption and a misinformed one. Actually banks’ deposits with SAMA in December ’08 have jumped to SR 41.1 bn from just SR 930 mn in October ’08, mostly in the form of reverse repo transactions with the central bank. Some could argue that what could help private borrowers now would be a commensurate drop in the cost of funding, as spreads have widened. Others would say that wider spreads represent some embedded higher risk premium and a lower profit margin made by bank deposits in the money market. During H2 ’08, banks were re-pricing most of their facilities upwards, as the cost and supply of funding were decreasing. Price stickiness in funding is an issue that private-sector actors express in our meetings with them. We think that sustaining loan growth and appetite in ’09 at the pace of ’08 will not be possible, given that the risk matrix has changed for both borrowers and lenders alike.

We also think that the end of the “mine is bigger” boom that many in the GCC experienced is negatively impacting on business perceptions in Saudi Arabia, as a result of possible ripple effects that might be felt in the Kingdom. But we think that these negative impressions could soon turn out to be positive as Saudi Arabia appears to be a value proposition with strong demographics, local demand, geography, no real estate bubbles, negligible sovereign local debt exposure and foreign assets that have increased rather than dissipated. This is not mere advertising speak; businesses could

very well begin to see real value in the domestic economy, more so than previously, coupled with a government's spending programme which will increase confidence in the economy.

The labour market seems to be on a general hiring freeze or witnessing some lay-offs, which businesses are reluctant to record. This is quite telling about private-sector expectations, given that the non-oil private sector grew at 4.3% y-o-y during one of Saudi Arabia's highest level of budgetary overspending. We do think that businesses, especially in the financial services sector as well the private sector at large, are in the process of re-structuring business operations. We have already noticed that the expatriate labour market is contracting but only gradually. We also think that a small number of nationals have been made redundant but its extent will depend on the degree of private sector appetite to downsize considerably its labour force.

The responses we received about the limited expectation of a revaluation do not continue to surprise us as businesses worry more about growth and receivables. The limited hope in the 2010 common GCC currency is also of no surprise to us. Finally, businesses have decided to be conservative after having incurred losses in all corners of the world. They are not unique in looking for safety in cash and bonds. We think that the stock market's poor performance does negatively impinge on business confidence, but we wonder how would businesses view the economy if the stock market had stabilised at 10,000 with oil prices in the mid-\$30s. We dare say that confidence would appear more positive if the local stock market was higher.

Although we have issued a far lengthier Index report than usual, we deem it was important to highlight many points from our survey at this stage and to share views from the market place with our readers. We do think that this is the time for private and public actors to work together. If we were to define succinctly what we think are the most important steps that would help create confidence:

- ▶ The government should maintain its spending and, at the same time, maintain its payments to the private sector on time. If the private sector begins to experience payment delays, the loss of confidence will be accelerated
- ▶ For its part, the private sector needs to retain its money in Saudi Arabia and re-invest profits in their businesses locally. We think that the risk elements are in many fewer sectors than is the case overseas. Investing in Saudi Arabia will also enhance employment possibilities for Saudi nationals
- ▶ Finally, we think that despite the downturn we are now witnessing, there is still some light at the end of the tunnel. The private sector must become more efficient, re-think its business models and trust that they are not in a zero-sum game

About the Index

The first business confidence index initiated by a Saudi bank, the SABB Index gauges market sentiment on a quarterly basis, through an extensive survey conducted by the Bank itself. For Q1 2009, our research took place between 12 and 19 February and was based on a sample of 765 business respondents. The respondents are representative of all three main business regions in the country – with 35% from the Central Region, 32% from the Eastern Region and 33% from the Western Region.

Methodology

The formula used in our statistical analysis is:
$$\text{Index} = \sum w_i D_i / (\text{base value } 2008 = 100)$$
; where w_i is weight, D_i is net balance of question i . Weights are assigned to each of the survey questions we use in the Index. Please note that, for balance, responses of a subjective nature have been eliminated when preparing the diffusion index.

The SABB Business Confidence Index has a base value of 100, with higher scores showing a positive result and lower scores demonstrating a negative trend in business confidence.

Industries surveyed

Real estate: 19%
Construction: 22%
Banking and finance: 15%
Oil, gas and petrochemicals: 8%
Marketing and advertising: 5%
Wholesale and retail: 16%
Others: 15%

Executive level of respondents

Chairmen: 28%
CEOs: 22%
Vice-Presidents: 17%
CFOs: 16%
Middle Managers: 9%
Junior Managers: 8%

Additional support provided by the Gulf Research Centre (GRC).



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Notes

Disclosure appendix

Analyst certification

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Dr. John Sfakianakis.

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Additional disclosures

- 1 - This report is dated as at 28 February 2009
- 2 - All market data included in this report are dated as at close 27 February 2009, unless otherwise indicated in this report.
- 3 - SABB has procedures to identify and manage any potential conflicts of interest that arise in connection with its Research business. A Chinese Wall is in place between the Investment Banking and Research businesses to ensure that any confidential and/or price-sensitive information is handled in an appropriate manner.

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