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GCC Economic and Investment Themes 2019

1 Oil Prices: Lower for longer?

2 GCC Banking M&A Wave

3 Gulf Bonds: Coming of Age

4 How Competitive are the GCC Economics

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Chapter 1

Executive Summary

Four themes cut across GCC as we step into 2019 in light of volatile oil prices. We believe that these themes are reshaping the economic landscape of GCC region. They are:

1. **Oil Prices: Lower for longer?**
2. **GCC Banking M&A Wave**
3. **Gulf Bonds: Coming of Age**
4. **How Competitive are the GCC Economics**

GCC economies showed a reversal in their growth trajectory in 2018, as all economies showed a positive growth. The fiscal position of GCC countries also improved during the year. The rise in oil prices triggered an upsurge of oil and non-oil activity in the region, resulting in considerable improvement of external and fiscal balances.

2018 witnessed significant volatility in oil prices during the second half of the year. The oil price breached USD 86 per barrel in October 2018 before retrieving back to below USD 60 per barrel mark. Going ahead in 2019, the extension of production cut by OPEC may ease the pressure on oil price in short-term.

The GCC countries have seen a surge in M&A activities in the last few years. As the macroeconomic scenario improve with new regulations in place, change in consumer behavior and demographics, M&A could be a key source of value addition both at operational and strategic level. We expect, GCC's banking sector in particular may see a new round of mergers and acquisitions.

The GCC debt market continues to be in the limelight and has made it to the top four economic themes in our report. J.P. Morgan announced the inclusion of Saudi Arabia, UAE, Bahrain, Kuwait and Qatar sovereign bonds to its Emerging Market Bond Index (EMBI). At a time when market sentiment is turning more cautious, expanding the universe of investible debt markets to higher-rated GCC countries should not only benefit the GCC states looking to deepen and diversify their capital markets, but should also open up new opportunities for domestic and global investors.

Lastly, we have highlighted the competitiveness of GCC economies. The countries in the GCC region have made significant efforts to reform and increase investments to improve their level of competitiveness. The region contains some of the world's most competitive economies, such as the UAE, Qatar, and Saudi Arabia, ranked 17, 25, and 30 out of 137 countries on the Global competitive index (GCI). While Bahrain, Oman, and the UAE have made notable gains in the past few years.

Economic Commentary

i. Economic Growth

In 2018, all GCC economies barring Bahrain grew at a pace brisker than what was seen in 2017, primarily due to the uptick in Oil prices during the year. Oil prices went on a rally in the first three quarters of 2018, fuelled by OPEC-related oil production cuts, U.S. sanctions on Iran, and supply shortages from Venezuela and Libya. Price of Brent crude closed at USD 86.29 per barrel on October 3 2018, the highest level since the beginning of 2015. However, prices corrected sharply at the end of the year, shedding more than 20% in November alone, due to concerns over a slowdown in global economic growth for 2019.

Weighing in factors such as the slowdown of global demand, OPEC's resumption of production cuts, U.S. Shale production and the trade war, oil prices are expected to stabilize at around at USD 65 per barrel. Tailwinds in the form of oil prices, in addition to the implementation of public investment projects, preparations for Expo 2020 and FIFA World Cup 2022 bode well for GCC countries, who are expected to sustain their growth through to 2019. Real GDP for GCC economies is forecasted to grow by 3% in 2019, followed by a growth of 2.4% in 2018 and a 0.4% contraction in 2017.

Real GDP Growth (in %)

Real GDP Growth	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	4.1	4.8	4.9	11.2	3.7	5.1
(2015)	4.1	-1.0	5.1	3.7	4.7	2.9
(2016)	1.7	2.2	3.0	2.1	5.0	3.5
(2017)	-0.9	-3.3	0.8	1.6	-0.9	3.8
(2018 e)	2.2	2.3	2.9	2.7	1.9	3.2
(2019 f)	**2.4**	**4.1**	**3.7**	**2.8**	**5.0**	**2.6**

Source: IMF

Real Oil GDP Growth Rates (in %)

Real Oil GDP Growth	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	2.1	4.0	2.6	10.4	1.4	0.4
(2015)	5.3	-1.7	5.2	-0.6	4.5	-0.1
(2016)	3.6	2.3	2.6	-0.9	3.6	-0.1
(2017)	-3.1	-7.8	-3.0	-0.7	-2.5	-0.7
(2018 e)	2.2	1.4	2.9	1.0	1.7	0.3
(2019 f)	**2.8**	**4.5**	**3.1**	**1.2**	**7.5**	**0.2**

Source: IMF

Real Non-Oil GDP Growth Rates (in %)

Real Non-Oil GDP Growth	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	6.5	6.6	6.3	12.6	7.0	7.4
(2015)	3.2	0.0	5.0	8.5	4.8	3.6
(2016)	0.2	2.0	3.2	5.3	6.2	4.3
(2017)	1.1	3.2	2.5	3.8	0.5	4.8
(2018 e)	2.3	3.5	2.9	4.3	2.0	3.9
(2019 f)	**2.1**	**3.5**	**3.9**	**4.3**	**3.0**	**3.1**

Source: IMF

Kuwait's Real GDP is forecasted to grow by 4.1% in 2019, driven by the rebound in Oil GDP from 1.4% in 2018 and -7.8% in 2017 to 4.5% in 2019. The implementation of projects that are in line with Kuwait's five year development plan is expected to be one of the positive drivers for economic growth in the country. Despite the embargo laid on Qatar in 2017, the country has managed to show resilience, contrary to populist views. With preparations for the FIFA World Cup 2022 gaining momentum, its economy is expected to grow steadily at 2.8% in 2019. Bahrain is the only GCC economy whose real GDP growth is expected to slow down when compared to 2018. The weakness in its fiscal position is expected to remain, constraining the government from effectively supporting its economy.

ii. Inflation

Inflation, annual change (%)

Real Non-Oil GDP Growth	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	2.2	3.2	4.1	4.3	2.5	1.7
(2015)	1.3	3.7	4.1	1.8	0.1	1.8
(2016)	2.0	3.5	1.6	2.7	1.1	2.8
(2017)	-0.9	1.5	2.0	0.4	1.6	1.4
(2018 e)	2.6	0.8	3.5	3.7	1.5	3.0
(2019 f)	**2.0**	**3.0**	**1.9**	**3.5**	**3.2**	**4.8**

Source: IMF

Barring Kuwait and Oman, inflation has risen amongst the GCC countries during 2018. Introduction of VAT, rise in fuel prices and other consolidation measures have had an inflationary effect on consumer prices in Saudi Arabia and the UAE during 2018. Moving forward, inflation is expected to ease in 2019 for both Saudi Arabia and the UAE, down to 2.0% and 1.9% from a higher level of 2.6% and 3.5% respectively seen in 2018. The weakening position of Bahrain and Oman will nudge both countries to pursue further fiscal consolidation measures, triggering a rise in consumer prices, consequently affecting their inflation. The introduction of VAT in Bahrain from 2019 is expected to have similar inflationary effects as witnessed in the case of UAE and Saudi Arabia during 2018. Bahrain's inflation is expected to rise to 4.8% in 2019, higher than 3.0% witnessed in 2018. The trade blockade of Qatar by some of the GCC peers caused inflation to edge up in 2018 to 3.7% compared to 0.4% in 2017. Importing goods from newer destinations and the surge in investments to support self-sufficiency helped Qatar satisfy its consumption/commodity needs. However, the resultant higher transportation cost and increased outlays at home could fuel inflation. The trend is expected to extend into 2019, resulting in an inflation of 3.5% in 2019.

iii. Fiscal Balance

The fiscal position of GCC countries in 2018 turned out to be far better than what was predicted a year ago. The rise in oil prices triggered an upsurge of oil and non-oil activity in the region, resulting in considerable improvement of external and fiscal balances. The increase in oil revenues eased the pressure on GCC governments and provided fiscal space for them to pursue public spending. However, with the U.S. Fed expected to make a few more rate hikes in 2019, GCC economies need to exhibit fiscal prudence and pursue reforms that would help them diversify from oil, as high oil prices could very well be a temporary phenomenon considering the headwinds that are around the corner.

Fiscal Balance

Fiscal Balance, as % of GDP	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	7.3	28.4	7.3	10.6	8.0	-0.9
(2015)	-15.8	5.6	-3.4	5.4	-15.9	-18.4
(2016)	-17.2	0.6	-2.0	-4.7	-21.2	-17.6
(2017)	-9.3	6.6	-1.6	-1.6	-12.9	-14.3
(2018 e)	-4.6	11.6	0.6	3.6	-2.0	-8.9
(2019 f)	**-1.7**	**12.0**	**1.3**	**10.5**	**0.8**	**-8.2**

Source: IMF

Saudi Arabia's fiscal deficit has been narrowing down since 2016, where its deficit was at 17.2% of GDP. The rebound in oil prices and the introduction of fiscal consolidation measures have helped the country reduce its deficit over the years. The trend is expected to continue with its deficit lowering to 1.7% in 2019. Similarly, the UAE and Oman have improved their fiscal positions over the years and are projected to run fiscal surpluses for 2019. Considering the fiscal space available to Saudi Arabia and the UAE, they have the headroom to adopt a slightly more expansionary fiscal policy to revive economic growth in the respetive countries and boost the non-oil industry.

Kuwait and Qatar are in the strongest positions among GCC economies, with fiscal surpluses of 12.0% and 10.5% of their respective GDPs for 2019. Their fiscal position is well balanced and expected to improve in the coming years. On the contrary, Bahrain remains the weakest among GCC economies, posting a deficit of 8.9% of the GDP in 2018 in spite of the rise in oil prices. The financial aid of USD 10 billion promised by its neighbours is expected to improve its fiscal position and help support its economy. Nevertheless, it's fiscal deficit is expected to be much higher than other GCC economies at 8.2% of the country's GDP in 2019.

Fiscal reforms often invloves trade-offs and can be painful to absorb in the short term. However, the long-term outcomes are expected to be beneficial in the quest of GCC countries to quell the over-dependence on oil. Due to this dependence, fiscal balances of GCC countries are still highly vulnerable to the fluctuations in oil prices. The cushion currently provided by higher oil prices should be used as an opportunity to strengthen their fiscal frameworks so that they have the required fiscal space to provide policy interventions when the macroeconomic climate turns unfavourable. Increasing revenues from non-oil sources also remain paramount in strengthening the fiscal reslience of GCC countries. Reforms such as reducing current expenditures in the form of subsidies and wages, introducing VAT followed by the implementation of a unified corporate taxation structure need to be mobilized in order to reduce the fiscal dependence on oil.

iv. Current Account Balance

Current Account Balance

Current Account Balance (% of GDP)	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	16.3	33.3	10.6	21.0	8.9	6.3
(2015)	-8.7	3.5	4.9	8.5	-15.9	-2.4
(2016)	-3.7	-4.6	3.7	-5.5	-18.7	-4.6
(2017)	2.2	5.9	6.9	3.8	-15.2	-4.5
(2018 e)	8.4	11.3	7.2	4.8	-3.3	-2.5
(2019 f)	**8.8**	**11.0**	**7.5**	**6.6**	**-0.5**	**-2.3**

Source: IMF

Production cuts undertaken by OPEC in addition to the supply constraints in countries like Iran, Venezuela and Libya have had a bearing on oil prices in 2018. GCC countries, whose export revenue is heavily dependent on Oil and Gas exports witnessed a considerable improvement in their current account balances during 2018 when compared to the previous year. The cumulative current account balance of oil importing countries shifted from a deficit of USD 68 billion in 2016 to a surplus of USD 120 billion in 2018[1].

Saudi Arabia's current account surplus increased from 2.2% of its GDP in 2017 to 8.4% in 2018, primarily due to the rise in oil prices. The surplus is expected to remain steady at 8.8% of its GDP in 2019, with a fall in expat remittances and imports. UAE's current account surplus is expected to marginally improve in 2019, at 7.5% of GDP, as oil revenues rise with increased oil production, complemented by non-oil exports and tourism. Qatar is expected to post a surplus of 6.6% of GDP in 2019, lower than its GCC counterparts due to the effects of the diplomatic crisis. Despite the rise in export revenues, Qatar has had to revisit its imports and change its trade partners, resulting in higher import costs. Qatar has also exited the OPEC and stated its intention to concentrate on Natural Gas over Oil. Kuwait's current account balance is expected to be the highest among all GCC nations in 2019. Historically, Kuwait's imports have remained low compared to its exports. It enjoyed high trade surpluses with oil trading at its all-time high, with an average current account balance between 2009 and 2014 at 33% of its GDP.

iv. Gross Debt

Gross Debt

Gross Debt (% of GDP)	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
(2009-2014 Avg.)	36.5	13.4	11.0	30.9	11.6	28.3
(2015)	5.8	4.7	18.7	35.5	15.5	66.0
(2016)	13.1	9.9	20.2	46.7	32.5	81.4
(2017)	17.2	20.6	19.7	53.8	46.9	88.5
(2018 e)	19.4	18.8	17.8	53.4	48.7	88.4
(2019 f)	**20.4**	**25.4**	**17.6**	**48.7**	**45.1**	**91.7**

Source: IMF

[1] IMF Regional Economic Outlook Nov 2018

GCC countries resorted to a combination of external borrowing and draw-down from reserves to plug the fiscal and current account deficits ever since the prices of Oil fell. They have accessed both international and domestic markets to finance their budget shortfalls in the past few years. The current year has been a difficult one for global bond markets with the rise in interest rates, dampening expectations of global growth and volatility in oil prices playing spoilsport as investor demand continues to fall. Having the global scenario at the backdrop, GCC bonds and sukuk markets have fared out slightly better than its emerging market counterparts in 2018. The oil price rally witnessed in the first three quarters of the year boded well for the GCC, as activity in the primary and secondary market picked up due to the positive outlook for the gulf nations.

The outlook for GCC bond market in 2019 remains clouded as fed rates are expected to be hiked further in the coming year. The fallout of U.S.-China trade war and the underperformance of Europe might have a telling impact on global growth moving forward, also affecting oil demand and prices. Considering the correlation between oil price and factors such as activity in the GCC market and Credit ratings in the past, the GCC bond markets need to contend with a few more headwinds in the year to come.

The UAE has the lowest debt to GDP among GCC countries at 17.8% in 2018 and is expected to carry forward this trend in 2019 as well, with a forecasted debt to GDP ratio of 17.6%. The UAE has been lagging behind its GCC neighbors in the local currency denominated bond markets unlike the USD-denominated bond market. In order to bridge the gap, UAE finalized and announced its federal debt law in 2018. It will allow the country to establish a federal debt management office and seek a credit rating for the country. Until now, the sovereign issuances have been at the level of individual emirates. The move will allow the country to issue bonds and sukuk at a federal level and establish a dirham-based sovereign yield curve that would help spur more corporate issuances.

Qatar has seen a betterment of fortunes in 2018 as S&P revised its outlook from 'negative to 'stable' during the year. Earlier in 2017, a negative outlook was affirmed to the country on account of the ongoing diplomatic standoff. However, a stable outlook has been reinstated after the country displayed macroeconomic resilience to overcome the effects of the embargo. Qatar's sovereign credit ratings were affirmed at 'AA-/A-1+' by S&P Global Rating. The agency also expects economic growth to accelerate and external accounts to remain in surplus from 2018-2021, except in the event of larger declines in oil prices. Qatar's gross debt to GDP is expected to tone down to 48.7% of the country's GDP in 2019.

Bahrain and Oman are two other GCC economies apart from Qatar to have a higher debt to GDP ratio compared to the rest. Bahrain's debt to GDP ratio is the highest among GCC countries at 88.4% in 2018. The ratio is expected to be higher in 2019 at 91.7% due to the country's need for finances to revive its economy. Bahrain's sovereign rating remains at junk territory with S&P affirming it at B+/B with a stable outlook, supported by the agency's opinion that financial aid from its neighbors would be forthcoming, if needed. The ratings were downgraded in December 2017 by S&P, citing the country's weak liquidity and increasing risks that would limit its access to international markets for financing. Saudi Arabia, UAE and Kuwait provided respite for the archipelagic state on October 2018 by announcing that they would provide USD 10 billion as funding support for Bahrain's fiscal program, which aims to eliminate the country's budget deficit by 2022.

Oman became the second GCC state after Bahrain to see it's long and short-term foreign and local currency sovereign ratings to plunge to junk territory. During the year, S&P and Fitch downgraded Oman's rating into junk category citing the country's fiscal challenges amidst a volatile oil price environment. This leaves Moody's as the only one among the large rating agencies to retain Oman at investment grade. Oman's gross debt to GDP is expected to reduce to 45.1% in 2019.

Theme 1
Oil Prices: Lower for longer?

The volatility in the oil prices has been significant in 2018 particularly during the second half. Until October oil price showed stellar recovery reaching as high as USD 86.1 per barrel. Since then the oil price has plummeted by over 30% breaching USD 60 per barrel mark. Growing inventories in US and forecast of continued higher output ensured that the prices continue to remain low. Fears surrounding weaker oil demand amid a potential slowdown in the global economy have also added to worries about the effectiveness of the supply cuts agreed in December 2018.

1-yr Brent crude oil price (USD/bbl)

Source: Reuters

Weaning influence of OPEC

Since its formation in 1960, OPEC has been a dominant player in oil market globally. The combined production of OPEC members on an average stood at 32.9 million barrels a day (market share of 32.8%) with over 80% of global oil reserves. However over the years, technological developments particularly by US has reduced the OPEC's share in global oil production which stood at 40.6% in 2012. The drilling companies in US have become much more efficient in the process of extracting oil at a lower cost. The breakeven oil price for some of the wells in Permian Midland area has reached as low as USD 31.6 with overall breakeven oil price below USD 60 per barrel on average. The increased production elsewhere had resulted in production cut for the first time, starting in 2017 with cooperation mainly between OPEC and some non-members including Russia.

In the last few years, OPEC has been trying to strike a balance between market share and oil price. Before the organization undertook the production cut in 2017 the focus was on to maintain the market share as it feared losing long-term market share to non-OPEC and shale producers. However, the surge in global supply and inventories that put the oil prices on a downward spiral made the organization to reset their priorities towards stabilizing the oil prices rather than maintaining the market share. OPEC along with 11 other nations decided to curb production by 1.2mbpd in an effort to increase oil price. However they have not seen much favorable positive impact on oil price.

U.S. however has continued to boost their oil production. According to EIA data, U.S. production in 2018 has averaged 1.5 MMbbl/d above 2017 levels. OPEC could be seen as the market balancing organization by adjusting their production to minimize supply glut. US has taken advantage by consistently raising its output and have been the beneficiary of the higher oil prices by capturing a wider market share in global production with production likely to surpass 12 million barrels a day by mid-2019. While the OPEC decided on extending the production cut in 2019, the decision seems to be ineffective on the oil prices which continue to remain under downward pressure. With demand side also playing a role to drive the oil price down, OPEC's ability to determine oil price is weakening.

Outlook for 2019

Global oil supply is forecast to increase by 1 million b/d in 2019 after accounting for expected production cut by OPEC by 1.2 million b/d in 2019[2]. Global consumption on the other hand is expected to increase by 1.29 million b/d in 2019, with growth largely coming from China, the United States, and India. In December 2018, OPEC agreed to cut 1.2 million barrels per day. Members will cut 800,000 barrels per day while allies are expected to cut down production by 400,000 bpd which would continue for six months with a goal to boost prices to USD 70 a barrel in 2019. Various investment banks have forecasted their expectation on oil price in 2019 varying between USD 61 to 73 bbl. Although extension of production cut may ease the pressure on oil price in short-term, any possibility of upward movement in oil prices beyond USD 80 bbl remain bleak.

Brent Crude Oil price forecast (USD/bbl)

Agency	2019
EIA	61
Goldman Sachs	70
Bank of America Merrill Lynch	70
JP Morgan Chase & Co.	73

Source: EIA, Oilprice website, CNBC

[2] OPEC

Theme 2
GCC Banking M&A Wave

Looking from the viewpoint of the management of a company, there are several incentives for them to favor mergers and acquisitions. They offer an easier alternative to developing new competencies in-house and open up new business opportunities quicker. Mergers and Acquisitions are highly attractive options for companies who wish to scale up their operations, widen their product offerings and expand their geographic presence. In certain cases, mergers and acquisitions take place across different industries so that the acquirer can diversify their business. Certain mergers deals are done within the same business lines for the purpose of consolidation, removing inefficiencies and scaling up. For banking industry, M&A is a cost effective way to restructure the banking system by eliminating institutions that are perceived as inefficient and without adequate liquidity and strong asset bases, thus creating larger entities that are financially more robust and efficient, as they benefit from more economies of scale. There have been several mergers and acquisition in the region, however we have compiled a list wherein both the target and acquirer were publicly listed companies.

Merger/Acquisitions between listed GCC companies in 2018

Target Name	Target Industry	Target Nation	Acquirer Name	Acquirer Industry	Acquirer Nation	Deal Size (USD MN)	Date Effective	Form of the Transaction
Oman Chlorine	Chemical	Oman	Al Anwar Holdings	Construction Materials	Oman	-	Jan-18	Acquisition Of Partial Interest
Oman ORIX Leasing Co	Credit Institutions	Oman	National Finance Co	Credit Institutions	Oman	16	Mar-18	Merger
National Biscuit Industries Ltd	Food & Beverage	Oman	Al Anwar Holdings	Construction Materials	Oman	-	Apr-18	Acquisition Of Partial Interest
Bank Aljazira	Banks	Saudi Arabia	Ahli United Bank	Banks	Bahrain	173	Apr-18	Acquisition Of Partial Interest
Gulf North Africa Holding Co	Real Estate	Kuwait	Al Aman Investment Co	Asset Management	Kuwait	3	Jul-18	Acquisition Of Partial Interest
Global Investment House	Financials	Kuwait	KAMCO Investment Co	Asset Management	Kuwait	158	Sep-18	Acquisition Of Majority Assets
Al-Kout Industrial Projects Co	Chemical	Kuwait	Boubyan Petrochemical Co	Financials	Kuwait	93	Oct-18	Acquisition Of Majority Assets

Source: Reuters

Creation of 'mega banks'/'national champions'

GCC countries have witnessed a surge in high-profile merger announcements in recent times, especially in the banking sector. The presence of unusually high number of banks and the fall in profitability have triggered the need for consolidation. Consolidation would provide them with higher pricing power and reduce the pressure on funding costs. It would also help in scaling up operations and widening the geographic scope for these banking institutions. The rise or fall of banking assets in the GCC has always had a high correlation with the countries' GDP, which in turn is correlated with oil prices. After the fall in oil prices during 2014, GCC governments have had to dip into government deposits to offset the impact of loss in oil revenues, putting pressure on the regional banks. In addition, the increase in compliance cost, introduction of VAT and keeping abreast with the technological developments have affected them from a cost perspective. Therefore, in order to stay competitive and profitable, mergers could be a viable option.

The merger between First Gulf Bank and National Bank of Abu Dhabi has triggered a series of announcements regarding mergers within the industry across GCC countries. In Saudi Arabia, Saudi British Bank and Alawwal Bank finalized a merger agreement in May 2018 to create the country's third-largest bank by assets. Likewise, activity in Qatar's banking industry was also long expected considering the presence of 18 local and international banks for a population of 2.6 million[3]. International Bank of Qatar and Barwa Bank announced the signing of a merger agreement to combine both entities to form a Sharia compliant financial institution. Another high-profile likely merger between Kuwait Finance House and Ahli United Bank is expected to result in second biggest Islamic bank in the GCC after Al Rajhi Bank. Standalone KFH and AUB have their footprint in six and eight countries respectively. If merger materializes, the merged entity will have presence in twelve countries. Following the merger of First Abu Dhabi bank, Abu Dhabi Commercial Bank (ADCB) is exploring the possibility of a merger with its local counterparts Union National Bank (UNB) and the Sharia-compliant lender Al Hilal Bank. The consolidation of these three lenders would create an entity with total assets worth USD 113bn, making it the fifth biggest bank in the GCC region.

Mergers and Acquisitions in the GCC Banking sector (Inter-GCC) since 2011

Target Name	Acquirer Name	Deal Value (USD Mn.)	Effective Date	Acquirer Nation
First Gulf Bank PJSC	National Bank of Abu Dhabi	14,844	Mar-2017	UAE
Barclays PLC - Retail Operations	Abu Dhabi Islamic Bank PSJC	162	Sep-2014	UAE
BMI Bank BSCC	Al Salam Bank Bahrain BSC	145	Feb-2014	Bahrain
Lloyds Banking Group PLC-Onshore Retail & Commercial Banking Assets	HSBC Bank Middle East Ltd	-	Apr-2013	UAE
HSBC Bank Middle East Ltd	Oman International Bank	715	Jun-2012	Oman
Dubai Bank PJSC	Emirates NBD Bank PJSC	-	Oct-2011	UAE
International Bank of Qatar-Islamic Banking Retail Operations	Barwa Bank QSC	-	Aug-2011	Qatar

Source: Reuters

In the past two decades, there have been very few mergers among local banks in the GCC. Majority of the M&A activity in the sector were in the form of cross border acquisitions to widen the geographic presence. Two of the biggest banking mergers took place in the UAE, nearly a decade apart from each other. Formation of Emirates NBD and First Bank of Abu Dhabi were significant deals for the UAE, where on both occasions, the biggest bank in the country was formed.

The environment for consolidation is stronger now than a decade ago. The fall in oil prices may be a significant trigger as more than 80 per cent of the Gulf's top 50 banks by assets are part owned by arms of GCC states. For instance, Government of Saudi Arabia owns 20.3% stake in Saudi Arabia's largest bank (National Commercial Bank) while its Public Investment Fund holds a 44.3% stake. Qatar Investment Authority holds 50% shares of Qatar's largest bank (Qatar National Bank). 33.5% of UAE's largest bank (First Abu Dhabi Bank) is owned by the Abu Dhabi Investment Council. Therefore, becoming a bigger bank strengthens ties to the government through business flow. In addition, it increases their resilience to credit or liquidity risk. However, there are instances where larger banks are mandated to acquire smaller banks with poor asset quality due to common government ownership. Those cases would not be value accretive to the private shareholders of the larger bank, who would be particularly averse to M&A activity because it would mean a dilution of their position. In terms of composition of banking systems while UAE, Oman and Bahrain are deemed overbanked, Saudi Arabia has relatively few domestic banking institutions which points to a less likelihood of M&A activity in the country.

[3] Reuters

M&A Deals: Hype over substance?

Mergers are one of the widely adopted corporate strategies to help an organization grow. Mergers may lead to a wide range of benefits including increased market share, diversification of the product line, integration of supply chain, gaining access to Research & Development technology and patents, tax benefits etc. The GCC banking sector, which has been fairly dormant in terms of major M&A activity over the past two decades, has seen a sudden surge in M&A related announcements lately. Banks across the region are expected to witness a phase of consolidation due to the overbanked nature of the GCC region in addition to the uncertainties caused by fluctuation in oil prices to the economy. The economy and the banking sector as a whole would benefit from the change in dynamics, as stronger and more resilient banks are expected to emerge out of this phase. However, all mergers do not create value to the businesses and the shareholders. A study made by KPMG concluded that about 83% of total mergers deals worldwide failed to create value for the associated shareholders.

A merger could be deemed successful only if the combination of the parent entities create enough synergies over and above the costs incurred to substantiate the need for the entities to merge rather than to work individually. The performance metrics of some of the major GCC banking mergers have shown that the performance has either been in line or deteriorated over a period of time after a merger. Despite considering the varying nature of macroeconomic conditions observed during some of the high-profile banking mergers in the region, there has been little evidence to suggest that they have been value accretive for both sets of shareholders involved (*read GCC M&A report for more details*).

Theme 3
Gulf Bonds: Coming of Age

J.P. Morgan has recently announced the inclusion of Saudi Arabia, UAE, Bahrain, Kuwait and Qatar sovereign bonds to its Emerging Market Bond Index (EMBI) from January 2019. In order to qualify for index the maturity of the debt should be greater than one year with a minimum face value of USD 500 million. Although some GCC countries are already included in other bond indices, their contributions are small, and the scope for inclusion is limited by countries' relatively high credit ratings. For instance, GCC issuers represent less than 5% of the Bloomberg Barclay's Global Aggregate Index. In contrast, the move to include them in the EMBI-GD will add USD 150bn to the index. This reflects the USD 127bn issued by GCC sovereigns between 2014 and 2017 plus the USD 32bn issued in 2018.

Overall, EMBI-GD index could lead to a significant increase in demand for GCC sovereign bond issues with the new countries, which will be included in EMBI Global Diversified (EMBIGD), EMBI Global as well as the EURO-EMBIG series, will represent around 11.2 per cent weightage on the index, with Saudi Arabia taking the maximum of 3.1 per cent, while the UAE will get 2.6 per cent weightage. Qatar, Bahrain and Kuwait will get 2.6 per cent, 2.1 per cent and 0.8 per cent weightage, respectively, according to J.P. Morgan. Oman is already included in the index with a weight of 2.6% on May 31, 2018. The JPMorgan's emerging market bond index inclusion will widen the investor base and could lead to increased liquidity of GCC bonds and Sukuk.

Passive investment by index-tracking funds could amount to USD 30bn to USD 45bn of new demand, or about 30% of the value of outstanding GCC sovereign issuance. This would lead to a decline in sovereign spreads relative to international benchmarks, reducing the premium they pay relative to similar or lower rated issuers. For instance, this could amount to up to 30 basis points for Qatar. This passive demand would further ease access to global financial markets and likely lower funding costs, including for corporates. With international bond issuance by corporates also significant at about USD 40bn from 2014 to the first half of 2018 securing a reduction in financing costs could result in higher private investment and stronger and more broad-based economic growth. Easing access to global financial markets would help ease the impact of tightening global financial conditions and provide an important channel to mitigate the risk of further bouts of financial market volatility.

GCC bonds offer higher risk-adjusted returns than their emerging market peers. This is due to their robust credit metrics due to the presence of higher fiscal reserves underpinned by strong sovereign ratings. Further, the correlation of GCC bonds with other asset classes remain low, which argues for their inclusion in investor portfolio. In the environment of increasing oil prices, the outlook could only get better.

Low correlation of GCC bonds seen with JPM EMBI

Asset class/ Index	S&P GCC Bond	S&P 500	MSCI WORLD	MSCI EM	Gold	Commodity Index	JPM EMBI ETF	US 10yr Treasury
S&P GCC Bond	1.00	0.87	0.76	0.25	0.05	-0.48	0.38	0.36
S&P 500		1.00	0.97	0.56	0.13	-0.22	0.19	-0.09
MSCI WORLD			1.00	0.74	0.21	-0.02	0.24	-0.26
MSCI EM				1.00	0.50	0.54	0.40	-0.53
Gold					1.00	0.49	0.49	-0.09
Commodity Index						1.00	0.23	-0.63
JPM EMBI ETF							1.00	0.36
US 10yr Treasury								1.00

Source: Reuters, S&P, Marmore research

The correlation of the S&P GCC Bond Index with that of the JPM EMBI ETF is only 0.38. This suggests that if the GCC countries are added to the JPM EMBI, the overall risk of the index would go down providing a higher risk reward ratio to the investors.

Not only conventional bonds but also Sukuk (Islamic bonds) from the region will be included in the index provided they are rated. Inclusion in the index will increase the demand for GCC bonds and Sukuk and this bid will assist in spread tightening in the near future.

GCC countries combined have issued a quarter of all new debt sold by emerging markets in each of the last three years. Currently, they account for approximately 14 per cent of total outstanding EM debt stock. The total domestic and USD-denominated debt outstanding from GCC issuers is about USD 317bn. Dollar denominated debt accounts for 68%. While the USD debt issuance from the Middle East has received widespread attention, the local currency market has been growing too.

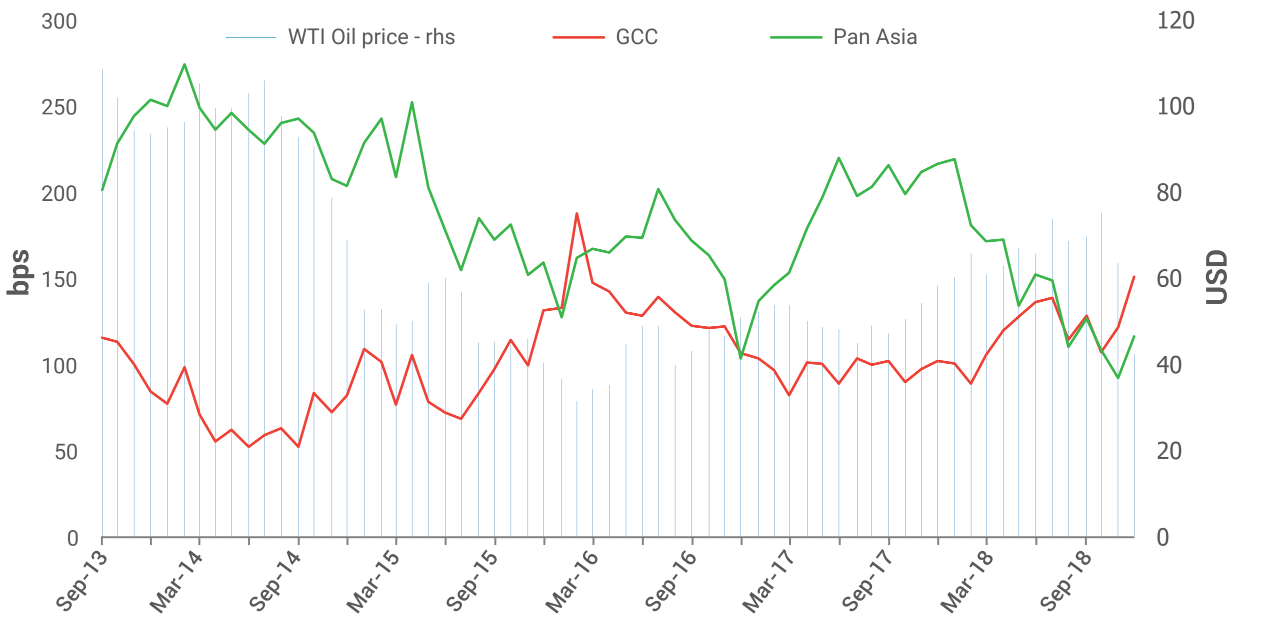
Saudi Arabia has been the leader in developing a domestic debt market, having reduced its reliance on USD funding to just over 30 per cent of its dollar-denominated debt as percentage of total bonds issued. The UAE, on the other hand, has relied solely on USD issuance. Kuwait's domestic currency bond market is worth watching, given that only 54% of its funding comes from USD issuance.

J.P. Morgan's decision follows a surge in debt issuance from the Gulf Arab region in the past few years, as low oil prices force most countries to fund part of their state spending in the international debt markets.

GCC index inclusion is a timely recognition of the fact that issuance from the region represents over 14 per cent of the stock of emerging market debt, and provides important diversification benefits. The tailwind resulting from the inclusion headline, coupled with pegged currencies, strong oil prices, relative immunity from trade wars and high credit quality, leads us to the view that the GCC has better value than the rest of the emerging markets.

While the GCC region has, in the past, traded at a tighter credit spread relative to other emerging market peers, the sharp correction in oil prices in 2015 has reversed that relationship, with the GCC region trading with a higher risk premium versus the broader peer group. Current trading levels seem attractive, particularly so given the recovery in energy prices.

GCC vs. Pan Asia Spreads (Benchmarked against: 10yr US Treasury)



Source: S&P, Marmore research

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Including GCC sovereign debt could prove to be a major boost to the region, supporting overall debt issuance. The inclusion will allow sovereigns to issue debt to a new audience of EM credit-focused investors, which should increase primary demand. GCC bonds are likely to become more visible to international investors and the inclusion is expected to significantly increase the size of the investible emerging-market universe and allow investors to consider GCC bonds when they want to reduce risk in a flight to quality, potentially reducing the volatility of emerging market bond portfolio flows.

Kuwait and Bahrain should benefit from the EMBI diversified weighting approach, which reduces the weight of the largest issuers relative to their amount outstanding. Flows could reach around 50 per cent of Kuwait's outstanding external bonds. Flows into large issuers such as Saudi Arabia and Qatar will be smaller in percentage-of-debt outstanding terms.

Bahrain will emerge as the biggest beneficiary out of EMBI inclusion. This will provide not only large flows as a per cent of debt outstanding, but is also likely to be crucial for future external financing needs. One of the clear benefits of being a member of a major benchmark is that investors generally have at least some exposure to each country to avoid deviating too much from the benchmark. Some of the sovereign bonds are currently trading at relatively wider spreads compared to their similar-rated peers, on the back of the high level of issuances in recent years and geopolitical risks.

At a time when market sentiment is turning more cautious, expanding the universe of investible debt markets to higher-rated GCC countries should not only benefit the GCC states looking to deepen and diversify their capital markets, but should also open up new opportunities for global investors. Most investors are aware of the debt issuance from the region, but the demand story may soon be picking up as well.

Theme 4
How Competitive are the GCC Economies?

The countries in the GCC region have made significant efforts to reform and increase investments to improve their level of competitiveness. The region contains some of the world's most competitive economies, such as the UAE, Qatar, and Saudi Arabia, ranked 17, 25, and 30 out of 137 countries on the Global competitive index (GCI) developed by The World Bank. While Bahrain, Oman, and the UAE have made notable gains in the past few years. Of the 12 pillars of the GCI, infrastructure and technological readiness are the areas where the Gulf region has made the most significant progress over the past decade relative to OECD countries, a result of heavy investments in transport and information and communication technologies (ICT) connectivity. Investments in infrastructure and connectivity were particularly notable as the total value of infrastructure projects in the planning or delivery stage amounted to USD 2.7tn in 2017.

Similarly, the impact of investment booms and busts has been largely limited to the financial sector. In addition, perceptions of public institutions among businesses improved, while the perceived ethics of private boards and managers has deteriorated according to the WEF Survey.

Growth in the Gulf Cooperation Council countries (GCC) is estimated to be 2.6% in 2018 and 2.9% in 2019[4]. This is mainly due to the implementation of public investment projects, including those consistent with the five-year development plan in Kuwait, infrastructure investment projects ahead of the FIFA 2022 World Cup in Qatar, and ongoing preparations for Expo 2020 in the UAE. In Bahrain, the expected fiscal consolidation is projected to dampen non-oil activity, despite rising aluminium production capacity.

Key Macro-economic indicators

Country	Real GDP growth	Inflation	Fiscal Balance	Current A/c balance
Bahrain	3.2%	3.0%	-8.9%	-2.5%
Kuwait	2.3%	0.8%	11.6%	11.3%
Oman	1.9%	1.5%	-2%	-3.3%
Qatar	2.7%	3.7%	3.6%	4.8%
Saudi Arabia	2.2%	2.6%	-4.7%	8.4%
UAE	2.9%	3.5%	0.6%	7.2%

Source: IMF | Fiscal and Current account balance are % of GDP

Progress is also being made in improving the business environment and encouraging private sector development. Bahrain, Kuwait, Qatar, Saudi Arabia, and the UAE are in the process of implementing policies to ease the time and cost of starting a business by introducing one-stop registration, and, in some cases, using e-government technologies. Other reforms include streamlining customs procedures in Saudi Arabia, enacting new laws to support small and medium-size enterprises, developing and strengthening public-private partnership frameworks particularly in Kuwait and Qatar and improving the bankruptcy framework in UAE.

To further improve the business environment, GCC countries need to ease access to finance. In this context, developing domestic capital markets as an alternative and complementary source of funding could prove beneficial.

[4] IIF

Doing Business Ranking

Economy	Global Rank	Starting Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Minority Investors	Paying Taxes	Trading across Borders	Enforcing Contracts	Resolving Insolvency
U.S.	8	53	26	54	38	3	50	37	36	16	3
UK	9	19	17	7	42	32	15	23	30	32	14
UAE	**11**	**25**	**5**	**1**	**7**	**44**	**15**	**2**	**98**	**9**	**75**
Japan	39	93	44	22	48	85	64	97	56	52	1
China	46	28	121	14	27	73	64	114	65	6	61
Bahrain	**62**	**66**	**57**	**82**	**26**	**112**	**38**	**5**	**77**	**128**	**93**
India	77	137	52	24	166	22	7	121	80	163	108
Oman	**78**	**37**	**66**	**66**	**52**	**134**	**125**	**12**	**72**	**73**	**100**
Qatar	**83**	**84**	**20**	**69**	**20**	**124**	**178**	**2**	**97**	**122**	**120**
KSA	**92**	**141**	**36**	**64**	**24**	**112**	**7**	**78**	**158**	**59**	**168**
Kuwait	**97**	**133**	**131**	**95**	**69**	**134**	**72**	**7**	**159**	**77**	**115**
Brazil	109	140	175	40	137	99	48	184	106	48	77
Egypt	120	109	68	96	125	60	72	159	171	160	101

Source: World Bank, Marmore research | Rank <30 (Green); between 30-80 (Yellow); >80 (Red)

Key Issues/Challenges

The gap between the OECD and GCC has widened on two pillars, the macroeconomic environment and labor market efficiency. The macro economic environment of GCC countries was hit heavily by the decrease in oil prices, but implementation of effective countercyclical policies have shielded their economies from adverse consequences.

Lack of adequate talent and private-sector competition, along with low labor force participation, weigh down their capacity to innovate, by far their biggest weakness. Some of the other common challenges that remain in the region includes improvement in the quality of education and health care, sufficient scale of economic diversification, government effectiveness and transparency. Oil and gas remain the largest export from the region, accounting for close to half the region's merchandise exports.

Way forward

Changes needed to encourage more rapid diversification in the region include regulatory frameworks that ensure competition and support private-sector investment; improvements in the quality of education; openness to trade and foreign investment; and a financial sector that better meets the needs of micro, small, and medium enterprises (MSMEs).

With a growing youth population in GCC region, creating employment opportunities in the private sector is crucial to ensuring a prosperous future. The United Nations estimates that 3.8 million people will enter the labor force in the region by 2021. There is need for structural economic reform in order to diversify and increase productivity. Efficiency and productivity could be improved by continued privatization, reducing regulatory barriers to entry for domestic companies, and making business environments more welcoming for foreign direct investment and more conducive to the growth of small- and medium-sizes enterprises.

Global competitive index ranking

Source: World Bank

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about marmore

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To be the first choice for obtaining strategic intelligence on the MENA region.

Our mission
Serving businesses and institutions with reliable information and intelligence about MENA, needed to catalyse growth, understand the larger environment and facilitate decision-making.

Our aim
Advocate intellectual research on MENA economics, businesses and financial markets and provide customized, actionable solutions.

Our foundation
» *A subsidiary of Markaz: Investment bank and asset management firm with 40+ years of history*
» *Markaz research activities commenced in 2006*
» *Marmore established in 2010 to intensify the research activities*
» *Publishes research reports and provides consulting services*

published research

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Marmore's industry reports provide information on industry structure, key players, market analysis, demand drivers, competitive analysis and regulatory requirements.

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Infrastructure research highlights bottlenecks in the sector and areas requiring urgent investments. Our infrastructure report analyses the link between economic development and infrastructure and showcases supply & demand challenges in the GCC and investment opportunities.

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Marmore provides customized consulting services based on specific requirements of our clients. Marmore's bespoke consulting services marries the challenges of cost, time, scope and data availability to generate actionable outcomes that are specific to our clients' needs.

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» *Due diligence / Business evaluation*
» *Feasibility studies (market and financial)*
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How do we execute consulting engagement?
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» *Step 1: Requirement and scope analysis*
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» *Step 4: Fieldwork / research*
» *Step 5: Analysis & reporting*
» *Step 6: Review & approval*
» *Step 7: Report submission / presentation*

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