

GCC MARKET OVERVIEW AND ECONOMIC OUTLOOK 2017: A CHALLENGING TRANSFORMATION AHEAD TO ACHIEVE DESIRABLE GROWTH

Armando Guastella, Alex Menghi

**GCC market overview and
economic outlook 2017:
a challenging transformation
ahead to achieve desirable
growth**

Published by

Value Partners Management Consulting
Via Vespri Siciliani, 9
20146 Milano, Italy

December 2016

Written and edited by:

Armando Guastella, Alex Menghi

With the contribution of:

David Prat, Carlo Bagarolo, Ginevra Zanuso,
Matteo Cutrera

For more information on the issues raised
in the report please contact:

ali.guven@valuepartners.com,
vincenzo.natile@valuepartners.com

If you would like to subscribe
or to be removed from our mailing list
please write to:
subscription@valuepartners.com

valuepartners.com

Copyright

© Value Partners Management Consulting
All rights reserved

CONTENTS

EXECUTIVE SUMMARY	5
GCC COUNTRIES STATUS OVERVIEW	6
GCC ECONOMIC OUTLOOK 2017	7
KEY CHALLENGES FOR GCC COUNTRIES	10
CONCLUSION	17
AUTHORS	30
ABOUT VALUE PARTNERS	32

The middle-east, and in particular the Gulf Cooperation Council (GCC) countries, are currently affected by macro-economic instability and a difficult job market, mainly due to the drop in oil prices. This calls for a thorough and challenging transformation that GCC countries will need to undergo to be able to achieve desirable growth.

EXECUTIVE SUMMARY

Being highly oil dependent economies, GCC countries have been deeply affected by the recent oil price drop (-60% since 2013), causing macro-economic instability that hinders job creation and slows growth.

The oil price drop has largely impacted GCC public finances, mostly generated by the oil sector, and has hampered Foreign Direct Investment (FDI), that only UAE has been capable to retrieve to pre-crisis level.

This also impacted the job market, already concerned with a large youth unemployment rate, a population overly employed by state-owned companies and a non-oil private sector that remains relatively small and has been a limited source of growth and employment.

GDP growth in GCC countries is forecasted at +2.3% in 2017, far from the growth experienced in the past.

Oil price is the main driver of GCC economy and it is expected to remain around 51 USD in 2017. However, the forecast may be affected by a number of factors, including the increasing global oil production, uncertain consumption patterns and investments in the oil industry.

In this context, GCC countries are expected to remain in deficit in 2017 and face large fiscal adjustments in a very rigid public expenses environment. Still, the banking system is well capitalized, even though deposit growth has been negatively impacted by Governmental accounts that were reduced to cover the deficit.

Looking forward, GCC countries should decrease their dependence on oil through diversification, switch focus of growth from public to private, develop an ideal environment for SMEs and improve the banking system liquidity and solvency.

GCC COUNTRIES STATUS OVERVIEW

(1) From 111 USD/barrel to 47 USD in 2016Q3.

(2) An average of 45% of GDP is related to the oil sector.

(3) Average of 30% vs 87% in European countries.

(4) 21% vs 15% in European countries.

(5) KSA 29%, Bahrain 28%, Oman 21% and Kuwait 20%.

Gulf Cooperation Council countries are currently facing two main issues: macro-economic instability and the need for job creation.

Macro-economic instability is mainly linked to the reduction of oil prices, which since its peak in 2013 have decreased by ~60% (1). Being highly dependent (2) on oil-related sectors, GCC countries are aiming to diversify their economies. However, elements such as macro-economic stability, supportive regulatory and institutional frameworks are key prerequisites for diversification.

The reduction in oil price is also having a negative impact on public finances considering that 79% of Government revenues are generated by oil-related sectors. In particular, GCC countries are experiencing a significant decline in Government revenue, public spending, current account balance and international reserves (potentially). However, debt levels are low compared to worldwide benchmarks (3) and are expected to remain stable considering that the current oil price is still below the fiscal breakeven oil price for all GCC countries.

Another factor affecting macro-economic stability is the impact of foreign direct investments which are still lower than pre-crisis level (2008), except for UAE (+117% 2015 versus 2008).

Job creation is also an issue. GCC countries have a great share of expatriates and a large young population (4) that is heavily affected by high unemployment rates (5). Despite a significant rise in educational attainment across most of the region, mismatch of skills and employment opportunities continues to be cited by the private sector in the Arab States. Finally, a significant share of employment is provided by the Government and financed through volatile and exhaustible oil revenue.

GCC ECONOMIC OUTLOOK 2017

(6) Iraq, Syria, Yemen and Libya, which account for 5.2% of worldwide oil production.

GDP growth in GCC countries is forecasted at an average of +2.3% in 2017, far from the growth experienced in the past (see Exhibit 1 for details).

Growth will be influenced by oil price, which is expected to be around 51 USD/barrel in 2017. Some key factors impacting oil price evolution include:

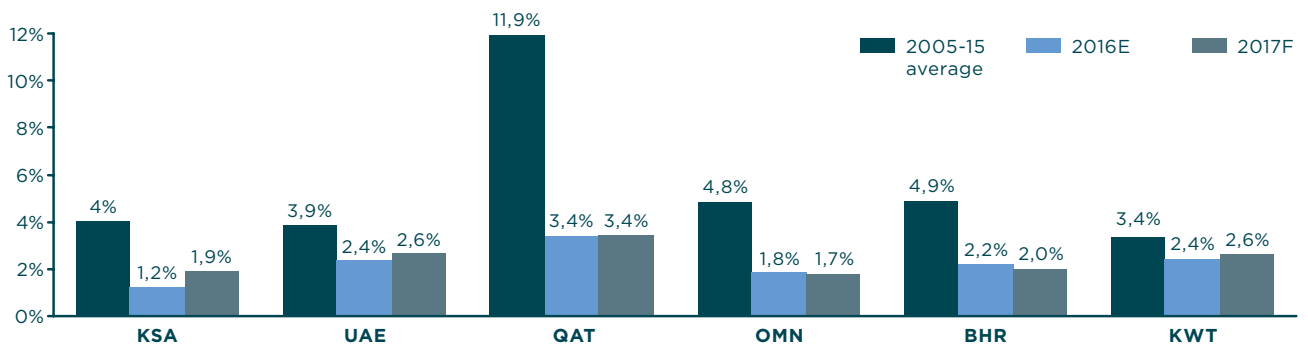
- **Oil production.** Oil production has heavily increased thanks to fracking in the US. However, Iran's faster-than-expected production increases and irregular production in countries affected by ongoing conflicts (6) are creating uncertainty around future production levels.
- **Stock.** Since 2014, the stock of oil in OECD countries has increased heavily, and storage capacity is expected to keep growing.

- **Investments in the oil industry.** Oil production is a capital-intensive industry. Since 2009 oil companies are being forced to slash capital expenditures amid a prolonged price drop and focus on high return projects for capital re-investment.

- **Oil consumption.** Brexit and the Chinese economy slowdown are key factors driving uncertainty on the evolution of oil demand and, consequently, of oil price.

- **Federal reserve impact.** An increase in interest rates would make USD more attractive as an investment. This has two main impacts: (i) being traded in USD, oil becomes more expensive for countries with other currencies, and (ii) a stronger dollar typically prompts speculative traders to sell oil futures and buy more of the US currency. On the other hand, if the new policy drives stronger growth, it would generate a positive impact on the price of commodities.

EXHIBIT 1
GDP growth evolution
by GCC country, %



OVERALL, GROWTH RISKS REMAIN TILTED TO THE DOWNSIDE. IN PARTICULAR, THE NEGATIVE IMPACT OF FISCAL CONSOLIDATION AND TIGHTENING BANKING SYSTEM'S LIQUIDITY

Source: IMF data June 2016, Value Partners analysis.

EXHIBIT 2
GCC countries fiscal revenues (surplus/deficit), %

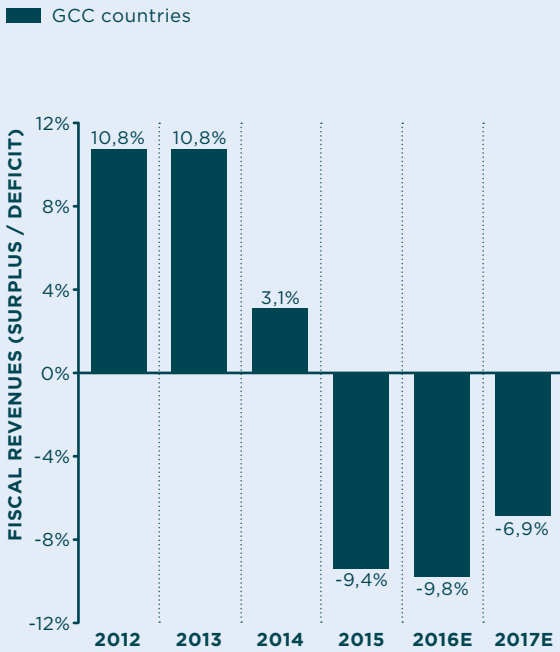
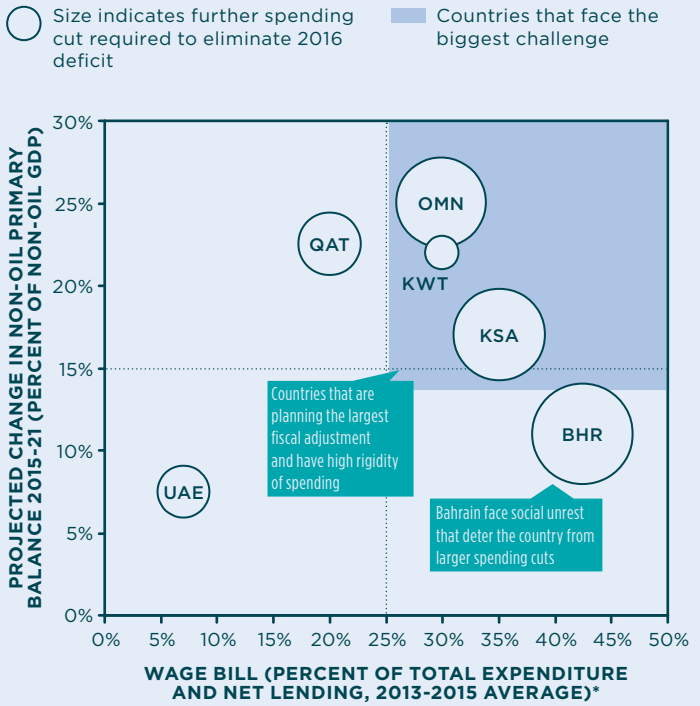
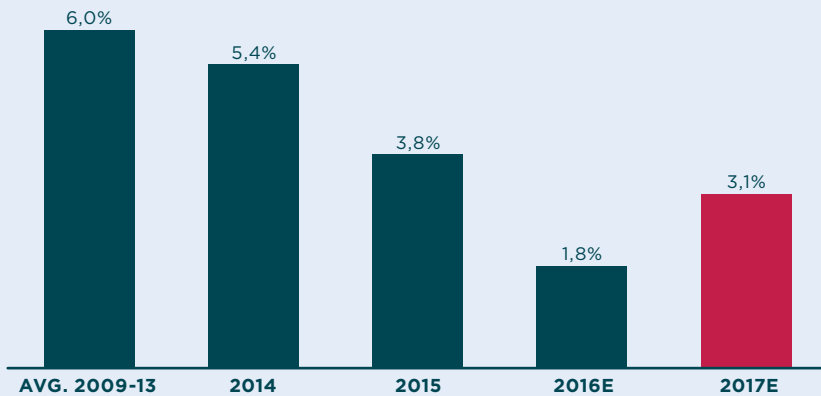


EXHIBIT 3
Positioning of GCC countries according to wage bill and projected change in non-oil primary balance 2015-2021, %



Note: * For Bahrain and the United Arab Emirates (UAE), the concept used is total expense rather than total expenditure and net lending.
 Source: International Monetary Fund (Economic outlook 2016 Oct), Value Partners analysis.

EXHIBIT 4
Non-oil GDP growth, %



Source: International Monetary Fund (Economic outlook 2016 Oct), Value Partners analysis.

(7) -5% Kuwait, -12% UAE, -17% Qatar, -35% Oman, -37% Saudi and -44% Bahrain.

Within this context, GCC countries will likely remain in deficit in 2017 (-6.9%) and the rigidity of public expenses will lead to further challenges (see Exhibit 2).

As Exhibit 3 demonstrates, eliminating 2016 budget deficit would demand an average spending cut of ~25% (7).

Policymakers have adopted a mix of spending cuts and revenue-raising solutions. Some countries have started to take action to rein in the public sector, even if the high rigidity of public expenditures (wages account for more than a third of total spending) will likely be a problem for policymakers. In particular, GCC countries are developing plans to increase private sector relevance, but this may be impacted in the short term by credit constraints.

Indeed, the slowdown in domestic deposits is likely to constrain credit supply over time and thus undermine the private sector's ability to pick up the slack from a downsizing public sector, with negative consequences for growth and jobs. As evidenced by Exhibit 4, non-oil GDP growth is expected to dip from 3.8% in 2015 to 1.8% in 2016, while in 2017, as the pace of fiscal consolidation eases, non-oil growth is forecasted to pick up to 3.1%.

Most countries have designed development plans to boost the growth of the private sector in strategic areas such as logistics, tourism, energy, financial services, healthcare and manufacturing, also by increasing the role of public private partnerships (PPPs). Furthermore, several countries are modernizing their investment and labor laws (Bahrain, Oman, Qatar, and Saudi Arabia) to incentivize the set-up of small and medium enterprises (SMEs), which are expected to be the main drivers of job creation.

The GCC banking system is well capitalized, but does not contribute to the financial recovery of GCC countries. Banks are experiencing lower margins and liquidity constraints triggered by oil prices and lower government spending. Deposit growth has been lower than expected mainly due to the decrease of Government deposits tightening liquidity.

Additionally, the weakening of public finance has led Moody's to decrease GCC banks' ratings. In particular, Moody's expects liquid asset buffers to decline by ~20% and increasing funding costs impacting profits.

This situation implies two main challenges for GCC banks:

- **Potential market consolidation.** Presently, ~50 banks fiercely compete in the UAE, a country with only 9 million people, a high credit penetration and a challenging macro-outlook. This means that the room for meaningful growth for these banks is very limited. Market consolidation is one way of addressing this situation.
- **Regulatory compliance.** The constant changes in the regulatory environment is putting significant pressure on banks' operating models (e.g. adapting to Basel III and IFRS 9). Additionally, Central Banks are working to further upgrade the regulatory framework in a very short time.

EXHIBIT 5
Summary of GCC countries status

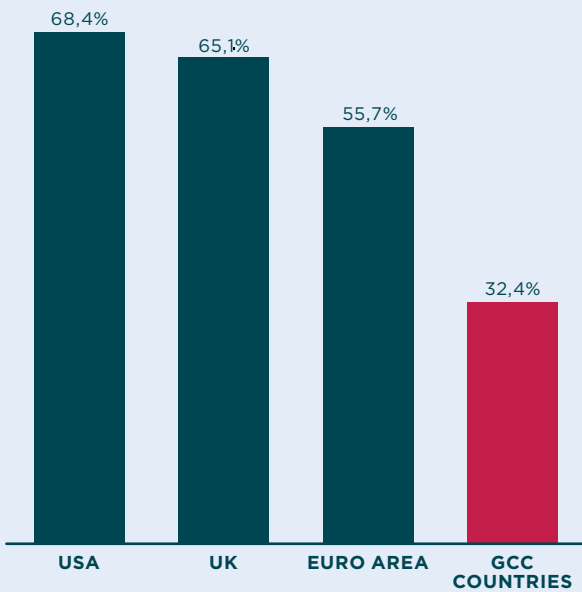
✓ Positive ✗ Negative ■ Neither positive or negative

COUNTRIES ANALYSED	GDP GROWTH 2015	FISCAL BALANCE 2015 (DEFICIT / SURPLUS)	BANKING SYSTEM STATUS	ECONOMY DIVERSIFICATION	GOVERNMENT DEBT 2015 (% GDP)	POLITICAL STABILITY
KSA	3,5%	-19%	✓	✗	7,8%	✓
UAE	5,0%	-3%	✓	✓	52,1%	✓
QAT	6,0%	+5%	✓	✗	35,8%	✓
OMN	3,3%	-10%	■	✗	7,0%	✓
BHR	3,0%	-14%	✓	✗	68,7%	✗
KWT	0,3%	-4%	■	✗	9,5%	✓

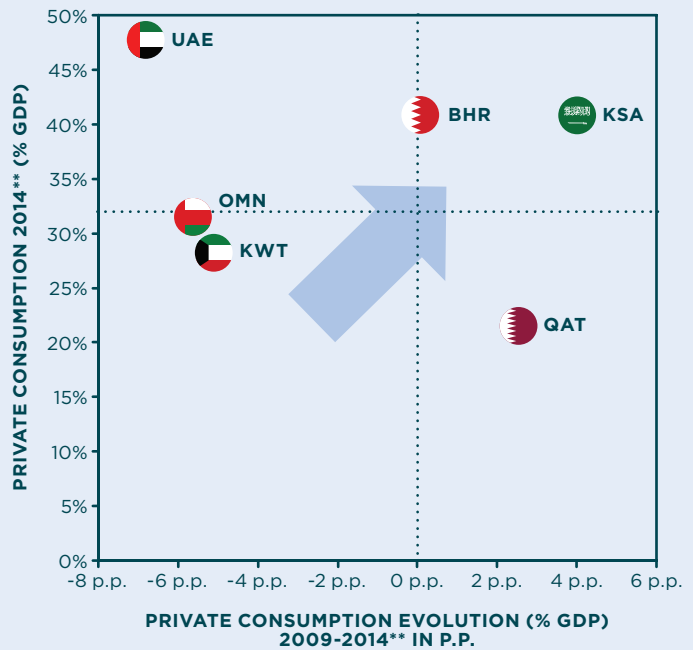
Source: IMF, World Bank, Deutsche Bank, Euler Hermes Economic Research, Value Partners analysis.

EXHIBIT 6
Level of private consumption over GDP, %, 2015*

DEVELOPED COUNTRIES HAVE A HIGH LEVEL OF PRIVATE CONSUMPTION



WITHIN GCC, UAE HAS THE LARGEST PRIVATE CONSUMPTION RATIO BUT IT HAS DECREASED IN THE LAST 5 YEARS



Notes: * 2014 for GCC countries due to availability of information; ** 2015 in Qatar and KSA.
Source: World Bank, Value Partners analysis.

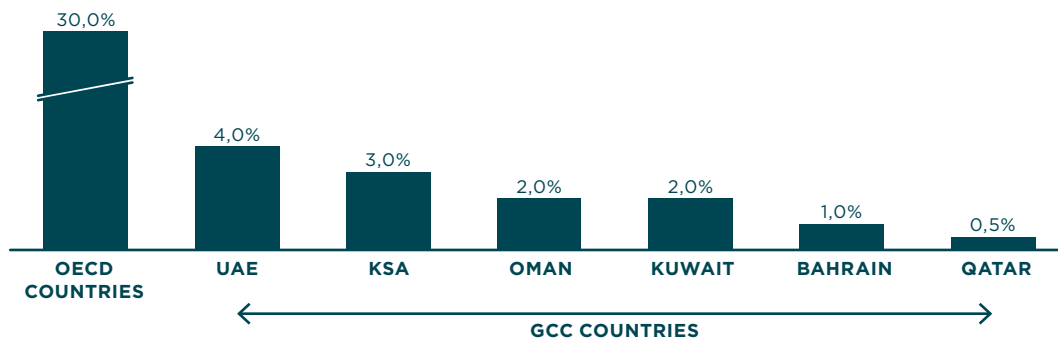
KEY CHALLENGES FOR GCC COUNTRIES

As previously described, the current situation presents some issues for GCC countries. Bahrain is the most damaged country due to political uncertainty; however, the whole area has been impacted by the drop in oil prices (see Exhibit 5).

In the coming years, GCC countries share four main challenges that, if successfully managed, may bring back pre-crisis growth rates:

- Decrease dependence on oil through diversification and consumption.**
 With a large percentage of fiscal revenues generated by the oil industry, GCC countries should focus on other sectors and transition to a consumer-led economy. UAE is the only country that has a more advanced level of diversification thanks to the development of strategic industries such as logistics and retail (see Exhibit 6).
- Switch focus of growth from public to private.**
 In some countries, the wage bill is a large portion of total expenditure and state-owned companies may be impacted by Government fundamental risks and inefficiencies. Some countries are already using PPPs (public private partnerships) and creating ad hoc regulatory frameworks to incentivize investments from private companies. UAE is the most advanced country in this area.
- Create an ideal environment for SMEs.**
 Small and Medium Enterprises are expected to be the main job generator in the following years as the public sector focuses on generating new efficiencies and financing the current wage bill. The privatization of services and an increase in the number of private companies are associated with the ease of business in the country, which consequently incentivizes the set-up of new SMEs. SMEs in GCC countries have a lot of financing issues, gathering a low percentage of total lending, mainly due to the historical heritage of oil-based economies, dominated by very large enterprises (see Exhibit 7).

EXHIBIT 7
Average share of SMEs' lending of total loans, %



Source: Jeddah Chamer "Small and Medium Enterprise in Saudi Arabia", Value Partners analysis.

- **Increase banking system liquidity and solvency.** The GCC banking system is well capitalized and solvent. However, the system faces the following issues that should be properly addressed:
 - Liquidity under further pressure related to Government decreasing deposits aimed at financing deficit
 - Deterioration of asset quality related to lower economic activity
 - Increasing pricing competition among banks.
- **Qatar** is implementing a large public investment program aimed at diversification, but this may imply potential risks of economy overheating, causing cost overruns and inflation due to large infrastructure spending, and an economy slowdown once the public investments taper off.
- **Oman** is currently undergoing an austerity plan, introducing constraints on required actions (e.g., fiscal adjustments), and key challenges related to banking liquidity, business environment improvement, economic growth and diversification.

Besides common challenges and trends, each GCC country is facing specific discontinuities:

- **KSA** is financially strong, but over-dependent on oil and affected by demographic pressures. It has recently announced an ambitious National Transformation Plan, which aims to introduce structural measures, such as improvements in public sector efficiency, privatization, further subsidy reforms and revenue diversification initiatives.
- **UAE** has already started a diversification plan and is growing at a stable pace. However, Government economic issues, mainly related to lower-than-expected performance from state-owned companies, and forthcoming debt maturity could impact GRE's debt levels and the overall banking system, leading to significant fiscal and financial risks.
- **Bahrain's** civil unrest and high level of debt generates uncertainty on the viability of its economy in low oil prices and the risk of losing the status of banking hub in the Middle-East. Furthermore, it challenges for further implementation of austerity plans without escalating social discontent.
- **Kuwait** has designed a new 4-year program with investment plans to reduce dependence on oil and boost private sector participation, prioritizing capital expenditure, encouraging private investments and creating jobs for nationals in the private sector. Additionally, the country needs to contain banks' exposure to the Real Estate and stock markets.

CONCLUSION

Being highly oil dependent economies, GCC countries have been strongly impacted by the recent oil price drop and are dealing with a difficult job market mainly due to high unemployment rates. The area is facing macro-economic instability with a 2017 outlook characterized by lower growth levels compared to the past, increasing deficit and large fiscal adjustments in a very rigid public expenses environment.

GCC countries should take actions to focus investments in the private sector, facilitate the proliferation of SMEs and improve the banking system in terms of liquidity and solvency.

To accomplish these challenging objectives it is necessary to undertake a comprehensive transformation enabled by a number of factors:

- Corporate governance systems allowing fast decision-making in line with GCC countries' objectives
- Organizational flexibility to achieve operational efficiency and effectiveness
- Strong strategic planning capabilities ensuring responsiveness to market changes
- Solid program management skills allowing the successful implementation of complex projects
- Ability to develop strategic partnerships with international players also leveraging technology transfer
- Required levels of know-how and skills among employees
- Processes and tools providing constant visibility and control of operational and financial performance at the right level of detail

All these elements are key prerequisites for a successful transformation.

The area is facing macro-economic instability with a 2017 outlook characterized by lower growth levels compared to the past, increasing deficit and large fiscal adjustments in a very rigid public expenses environment.

AUTHORS



ARMANDO GUASTELLA
Senior Engagement Manager, Dubai Office

armando.guastella@valuepartners.com



ALEX MENGHI
Senior Engagement Manager, Dubai Office

alex.menghi@valuepartners.com

Looking forward, GCC countries should undertake a comprehensive transformation aimed at decreasing their dependence on oil, switching focus of growth from public to private, developing an ideal environment for SMEs and improve the banking system liquidity and solvency.

ABOUT VALUE PARTNERS

Value Partners is a global management consulting firm that works with multinational corporations and high-potential entrepreneurial businesses to identify and pursue value enhancement initiatives via innovation, international expansion, and operational effectiveness.

As Value Partners, from defining the strategy to developing a detailed plan to reach ideal platform, we provide turnkey solutions for our clients.

Our solution services are mainly divided into three parts: diagnosis, analysis and value proposition, deployment.

Founded in Milan in 1993, over the years Value Partners has grown to over 30 global partners and more than 250 professional consultants from 23 countries.

It has offices in Milan, London, Istanbul, Dubai, São Paulo, Buenos Aires, Beijing, Shanghai, Hong Kong and Singapore.

Value Partners has built a portfolio of more than 350 international clients – from the original 10 in 1993 – with a worldwide revenue mix, as over 60 percent of the management consulting revenues are generated outside Europe.

Value Partners combines methodological approaches, analytical frameworks and professional tools with a practical hands-on attitude and a wealth of industry knowledge and executive capacity within many sectors.

In the **MENA region**, Value Partners assists from Istanbul and Dubai double-digit growth countries in the Gulf area (Qatar, Kuwait, Bahrain, Oman, Egypt) and Africa.

Value Partners has been doing business in this area for several years, mainly with projects in the Financial Services and Media & Telco sectors, carrying out successful projects in UAE, Kuwait, Qatar and, more recently, in Oman. We have also carried out Customer Relationship Management projects in Egypt and South Africa.

Value Partners is also present in Saudi Arabia, where we assist public institutions, some of the most important industrial and finance operators, as well as small and medium-size companies in growth and development operations.

We also flank local organizations and international groups seeking for growth opportunities in the Middle East and Africa.

For more information on the issues raised in this note please contact:

Ali Güven
Managing Director, Head of MENA Region
ali.guven@valuepartners.com

Vincenzo Natile
Partner, Dubai Office
vincenzo.natile@valuepartners.com

Find all the contact details on valuepartners.com

Milan
London
Istanbul
Dubai
São Paulo
Buenos Aires
Beijing
Shanghai
Hong Kong
Singapore