FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Saudi Arabia's Outlook to Negative; Affirms at 'A'

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Fitch Ratings - Hong Kong - 09 Nov 2020: Fitch Ratings has revised the Outlook on Saudi Arabia's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'A'.

KEY RATING DRIVERS

The revision of the Outlook on Saudi Arabia's IDRs reflects the continued weakening of its fiscal and external balance sheets, which has been accelerated by the coronavirus pandemic and lower oil prices, despite the government's strong commitment to fiscal consolidation. We forecast a decline in the Kingdom's sovereign net foreign assets (SNFA) to 60% of GDP by 2022 from about 72% of GDP in 2019-2020 as a result of debt issuance and reserve drawdowns, and we expect this to trend to continue over the medium term, although SNFA will likely remain higher than the 'A' median.

We expect the government budget deficit to widen to 12.8% of GDP in 2020 (equivalent to about USD90 billion), from 4.5% of GDP in 2019. This reflects a 33% drop in oil revenue, a 5% drop in non-oil revenue and 1% higher spending compared with last year. Significant structural fiscal measures will contain growth in spending and support non-oil revenue this year. The fiscal balance will also be buoyed by the collection of exceptional profits from government investments.

We expect fiscal deficits to narrow gradually to about 8% of GDP in 2021 and 5% of GDP in 2022, with risks tilted to the downside, in our view. This forecast assumes recovery of Brent oil prices to an average of USD50/bbl by 2022 and growth in the Kingdom's crude oil production to 9.7 million bbl/day by 2022 as oil production cuts under the OPEC+ agreement are tapered in 2021 and finally allowed to expire in 2022. The full-year effect of this year's VAT rate increase, the expiration of coronavirus-related spending and recovery in the non-oil economy will help narrow the fiscal deficits in 2021-2022.

However, further waves of the coronavirus, either in Saudi Arabia or elsewhere, and continued oil market weakness could upend these forecasts. We estimate that USD10/bbl lower average oil prices would lead to an increase of 4% of GDP in the fiscal deficit relative to our forecast, while a 1 million bbl/day decline in production would lead to an increase of 2% of GDP in the fiscal deficit. We estimate Saudi Arabia's fiscal break-even Brent oil price at an average of 67/bbl in 2020-2022.

The government projects that a stronger recovery in revenue and deeper spending cuts will lead to a more rapid narrowing of the fiscal deficit, to 5% of GDP in 2021 and 3% of GDP in 2022, with a view to achieving a balanced budget by 2023. However, we expect that macroeconomic and social realities will lead to a departure from these targets. In our assessment, achieving them would at least partly be dependent on more supportive oil prices and production than we expect or continued exceptional revenue from government investments and asset sales. The government is also likely to face pressure to maintain spending to support the recovery and the welfare of Saudi citizens, potentially offsetting the gains from higher VAT.

The government and broader public sector balance sheet will continue to deteriorate, although they will remain stronger than those of most 'A' category sovereigns. We expect the government to finance deficits primarily through debt, with a focus on domestic debt, while maintaining the trajectory of government reserve drawdowns specified in previous fiscal balance programmes. We expect government debt to reach about 35% of GDP by end-2020 and rise to 41% of GDP by 2022 (forecast 'A' category median: nearly 60% of GDP), from 23% of GDP in 2019.

Meanwhile, we expect the government reserve, consisting of deposits at the Saudi Arabian Monetary Authority (SAMA), to decline to 16% of GDP by 2020 and 12% of GDP in 2022, from 18% of GDP in 2019. Broader public sector entities including pension funds have scope to significantly increase their holdings of government domestic debt, which had already risen to 6% of GDP by 1H20, from 3% of GDP in 2019.

The fiscal deficits are mirrored in the current account deficit, a drawdown of SAMA reserves and a deterioration in the Kingdom's SNFA position from a strong starting point. We forecast a current account deficit of 6% of GDP in 2020, narrowing to 3% of GDP by 2022, from a surplus of 5% of GDP in 2019. SAMA reserves have also been affected this year by a USD40 billion re-allocation of assets to the Public Investment Fund (PIF). As a result, we expect SAMA reserves including gold to fall to USD456 billion by end-2020 and USD438 billion by end-2022, from USD515 billion at end-2019. Nevertheless, at 20 months of external payments, the reserve coverage ratio will remain the strongest among Fitch-rated sovereigns.

We estimate that the level of state-owned and government-related entity (GRE) debt reached about 22% of GDP in 2019, excluding banks. This is still moderate given the government's large role in the economy, and many GREs remain unlevered compared with international peers. However, estimated GRE debt is increasing, led by Saudi Aramco and the PIF and its portfolio companies. This will contribute to the erosion of Saudi Arabia's balance sheet strengths and to a worsening of its overall net external creditor position (to 28% of GDP by 2022, from an estimated 45% of GDP in 2020 and 51% of GDP in 2019, compared with a forecast net external creditor position of 9% for the 'A' median in 2022).

We expect real GDP to contract by about a little over 4% this year, equally driven by cuts in oil production and sweeping disruptions to economic activity as a result of the coronavirus. A dampened global demand outlook and contractionary fiscal policy are likely to keep oil and non-oil GDP growth muted at 2%-3% in 2021-2022. GDP contracted 7% yoy in 1H2020 (with a 5% contraction in the oil sector and an 8% contraction in the non-oil sector).

Saudi Arabia's 'A' IDRs also reflect the following key rating drivers:

The government has taken a number of structural fiscal measures this year to limit the impact of lower oil prices and the coronavirus pandemic on public finances, demonstrating its commitment to fiscal consolidation. As the coronavirus crisis subsides, we expect these measures to improve the government's non-oil primary deficit to 25% of non-oil GDP, from about 36% of non-oil GDP in 2019-2020 and 57% in 2014. It cut about 4% of GDP in spending from its budget this year to make room for about 5%-6% of GDP in additional coronavirus-related expenditures, including by suspending the cost of living allowance for government employees. The government also tripled the rate of VAT to 15% from July this year and raised customs duties.

The PIF will likely be in a position to support economic growth and partly offset the impact of government austerity through its domestic investments. These include a large theme park and entertainment complex outside Riyadh, tourist developments on the Red Sea coast and Saudi Arabian Military Industries. In addition to this year's USD40 billion transfer from SAMA, the PIF received significant liquidity as a result of the government's USD29 billion (equivalent) flotation of shares in Saudi Aramco. It is also expected to receive the equivalent of USD69 billion in instalments until 2028 from Saudi Aramco in consideration for the PIF's 70% stake in Saudi Basic Industries Corporation, which Saudi Aramco will partly pay for with debt.

Most structural features are weaker than the 'A' category median, including World Bank indicators of governance. In our view, the Saudi unemployment rate, which jumped to over 15% in 2Q20, could create economic and social pressure. The banking sector is well-capitalised and well-regulated, with an average Viability Rating (VR) of 'bbb', although Fitch has placed all Saudi banks' VRs on Rating Watch Negative, reflecting the risk of severe and prolonged deterioration in the domestic operating environment, despite more than 5% of GDP in liquidity support by SAMA.

ESG - Governance: Saudi Arabia has an ESG Relevance Score of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Saudi Arabia has a medium WBGI ranking in the 46th percentile.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to negative rating action/downgrade are:

- Public Finances: Further deterioration of the overall public finance position reflected in higher government debt/GDP, drawdowns of government assets or higher contingent liabilities.

- External Finances: Continued deterioration in Saudi Arabia's net external creditor position.

- Structural Features: A major escalation of geopolitical tensions that affects key economic infrastructure and activities over an extended period.

The main factors that could, individually or collectively, lead to positive rating action/upgrade:

- Public Finances: Fiscal consolidation or a rise in oil revenue that arrests the deterioration in the public sector balance sheet and accelerates progress towards sustainable fiscal balance.

- External Finances: A stabilisation of Saudi Arabia's external position, as reflected in SNFA/GDP net external debt/GDP and SAMA reserve metrics.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Saudi Arabia a score equivalent to a rating of 'A-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Public Finances: +1 notch, to reflect the large albeit declining government deposits held with the central bank as well as other public sector assets that could be mobilised to support government funding.

The removal of the -1 QO adjustment on Structural Features reflects Fitch's view that Saudi Arabia's political risks are reflected in the SRM, particularly in low scores on World Bank Governance Indicators

The removal of the +1 QO adjustment on External Finances reflects Fitch's view that Saudi Arabia's external balance sheet strengths are reflected in SRM, particularly in its high reserve coverage of external payments and SNFA/GDP.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

Brent crude will average USD41/bbl in 2020, USD45/bbl in 2021 and USD50/bbl in 2022.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Saudi Arabia has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and risks stemming from regional geopolitics and the rapid pace of change domestically are currently particularly high; this is therefore highly relevant to the rating and are a key rating driver with a high weight.

Saudi Arabia has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and Saudi Arabia and Saudi Arabia scores well below peers; this is therefore highly relevant to the rating and a key rating driver with a high weight.

Saudi Arabia has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as World Bank Governance Indicators have the highest weight in Fitch's SRM and the Voice and Accountability Pillar remains a standout weakness for Saudi Arabia; this is therefore relevant to the rating and a rating driver.

Saudi Arabia has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Saudi Arabia, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
KSA Sukuk Limited				
• senior unsecured	LT	A	Affirmed	A
Saudi Arabia	LT IDR	A Rating Outlook Negative	Affirmed	A Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+
•	LC LT IDR	A Rating Outlook Negative	Affirmed	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 22 Jul 2019)

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Sovereigns Middle East Asia-Pacific Saudi Arabia