SAUDI ARABIA COUNTRY REVIEW

SAUDI ORIX LEASING COMPANY

Contents

Kingdom of Saudi Arabia - Country Review

Country Demographics

Saudi Arabia is the largest country in Arabian Peninsula with a land area of 2.1 million km^2 and population of 31.8 million as reported for 2016. The Country is home to two holiest cities of Muslims i.e. Makkah and Madinah, which attracts millions of visitors every year, particularly during the Hajj. The Kingdom, conjures up just one image i.e. oil, however is also endowed with a wealth of other natural resources. The Country has spectacular archaeological remains at Mada'in Saleh (a UNESCO World Heritage Site), the southwest region has mountains, forests, exotic wildlife and there is coastline of more than 3,000 kilometers on the Red Sea and the Gulf that includes 1,300 islands.

Economy

Saudi Arabia is the world's largest oil exporter and reportedly has twenty-five percent of earth's known hydro carbon reserves, besides holding largest minerals deposits in the Gulf, including about 20 million tons of gold ore, 60 million tons of copper, 10 billion tons of phosphates and millions of tons of other elements. The Country has an oil based economy with oil accounting for 90% of government revenue and more than 40% of the total GDP. The Government, through its several five-year development plans, used oil revenue to transform its relatively underdeveloped, oil-based economy into that of a modern industrial state. While major developed and emerging economies were recording an indebtedness growth in 2008 financial downturn, the Kingdom, having a rare exception, eliminated national debt and managed to increase reserve assets to $732 billion.

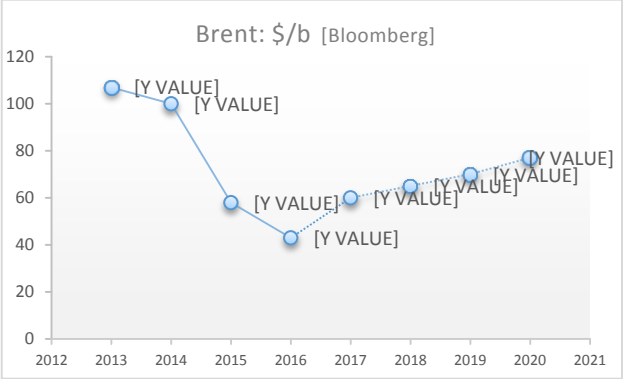
Government spending is the corner stone of the economy and underpins private sector through spending on education, health, social welfare, infrastructure, and transport. Although it outperformed while starting from a low base, still the non-oil private sector is relatively small and has potential to drive much of growth.

FIGURES IN US $	2011	2012	2013	2014	2015	2016
GDP Nominal in US $ Billions	669.5	734.0	746.7	756.4	654.3	644.9
Gross Fixed Capital Formation % to GDP	22.7	22.3	23.7	25.2	29.9	26.0
GDP Per Capita	48,722	50,655	52,251	53,889	55,391	55,125
Population in millions	28.0	28.9	29.4	30.0	30.9	31.8
Inflation %	3.7	2.9	3.5	2.7	2.2	3.5
Oil Price US$/b	110.9	112.0	108.9	98.9	52.4	44.0

Source: EIU/SAMA

Economic Outlook

Saudi Arabia is confronting an altogether different economic environment to that of just a few years ago, stemming from the 2014-2015 downfall in oil prices which has slashed the Kingdom's main source of revenue which makes 80 per cent of its total income. The Country has declared deficit in its budgets for the last few years, for the first time since 2007, and the Government has been forced to draw on its foreign reserves and issue bonds. The years eyed downgrading of credit rating due to sluggish growth, and slashed public spending, scale back of running projects, sharp stop on projects rollout, and stringent liquidity in the market as a result of fiscal financing.



The resulting altered economic landscape and growing demographic pressures have presented significant predicaments, transformed into cut on energy subsidies, reduction in wage allowances of public sector employees, unprecedented move of White Land tax, levy of fee on expatriate residents and introduction of 5% VAT in 2018. A number of other options are being pursued to shore up funds further, including privatization of state-owned entities and further reduction in subsidies and other fees are also in the offing. However, despite all this and cutting the budgeted spending, it is likely to have a fiscal deficit of 6% percent of GDP over the coming years. As the government struggles with the impact of a structural shift in the price of oil on both the fiscal position and balance of payments, the much tighter fiscal stance has been and will be a feature of the next five years' prognosis and it would be hard to return to the free-spending of the boom years, even if oil prices pick up.

In order to reduce its long-standing dependence on oil and move the fiscal position on to a sustainable footing, the Kingdom unveiled Vision 2030 — the most significant reform of the national economy in the country's eight decades of existence — that calls for a shift from government-led growth to the private sector taking a leading role in economic expansion. In implementing its radical development strategy, **National Transformation Plan** (**NTP)** aims to enhance nonoil revenue, promote small and medium enterprises and diversification of exports. It aims to boost foreign investment from $8.1bn in 2015 to $18.7bn by 2020 through deregulation of various sectors (health, utilities, education, transport and municipal services), providing a valuable stream of foreign

Vision 2030 Goals	2015	2030
Private sector share of GDP	40	65
SME % of GDP	20	35
Gas production, bn cm	108	216
Non-oil revenues, SAR billion	163	1,000
% of GDP	6.7	16.8
Non-oil exports/Non-oil GDP	16	50
FDI, % of GDP	3.8	5.7

exchange as well as a growth impetus. Expansion of religious tourism is also being promoted which is expected to provide a useful source of government revenue in the years ahead. Further, recognizing the economic potential and in an effort to create a more diversified economy, the development of the mining industry, trade and services, manufacturing, construction sector is one of a strategic objective of the NTP. As the economy is in the early stages of a transformation, the longer-term picture is unclear and the extent to which the government can succeed in implementing NTP will be key to the Kingdom's economic sustainability.

Key Economic Indicators	2014a	2015a	2016a	2017e	2018f	2019f	2020f
GDP							
Nominal GDP (SR bn)	2,836	2,454	2,419	2,564	2,717	2824	2934
Real GDP growth (%)	3.7	4.1	1.7	-0.7	1.0	2.0	2.2
Expenditure on GDP (% real change)							
Private consumption	6.1	6.8	2.2	2.0	2.0	3.0	3.4
Government consumption	12	-1.8	-17.3	0.8	1.0	2.0	1.9
Gross fixed investment	7.5	3.7	-14.4	-7.0	-0.5	4.6	4.1
Fiscal indicators (% of GDP)							
Budget revenue	36.8	25.1	21.5	26.4	28.0	28.9	28.6
Budget expenditure	39.1	39.9	34.3	35.4	35.2	35.7	35.1
Budget balance	-2.3	-14.8	-12.9	-8.9	-7.2	-6.8	-6.5
International reserves (US$ m)	732,353	616,418	535,797	482,217	491,862	482,024	

Source: EIU

Country's Rating

Based on the assumption that the oil prices would remain low for several years, rating agencies expected the Kingdom to record a sizable and sustained reduction in the revenues and fast depletion of its reserves, therefore, downgraded the Kingdom. The change in country rating has also affected the local banks as well because, as per rating agencies, the low oil price threatens to hurt the health of banks' balance sheets as well.

	Rating before the downgrade	**Current Rating**	**Outlook**
S&P	AA-	A-	Stable
Moody's	Aa3	A1	Stable
Fitch	AA	A+	Stable

KSA's Financial Services Sector

KSA's Financial Services Sector consists mainly of Government owned Specialized Credit Institutions, Commercial Banks and Finance Companies which are supervised and regulated by Saudi Arabian Monetary Agency (SAMA), the Central Bank of the KSA, established in 1952. Under the supervision of Saudi Arabian Monetary Agency (SAMA), the banking regulatory and supervisory framework has been strengthened and the payment and settlement systems have become modern and efficient. The government owned credit institutions continued achieving development objectives at the country level and the banking sectors has built-up profound standings.

Specialized Credit Institutions

The industrial infrastructure in the Kingdom has been built by public funds through five specialized credit institutions which provide long term concessionary credit to industry, agriculture and real estate. The institutions, each one operating with certain mandate, include Saudi Industrial Development Fund, Public Investment Fund, Agricultural Development Fund, Saudi Credit & Saving Bank and Real Estate Development Fund. These institutions own total assets of USD 79 billion and disbursed USD 92 billion since inception towards the end of 2017. [Note: Previously reported data has been modified due to restructuring of SCI]

Commercial Banks

Banking sector consists of 25 commercial banks, including branches of foreign banks, operating through 2,079 branches across all the regions of the country while employing 47,588 workers. Saudi Arabian banks have been traditionally well capitalized, with good loan-to-deposit ratios and low exposure to foreign debt, as a result of robust financial regulation entailing high reserve and liquidity requirements.

The banking sector recorded a strong activity growth till 2014 amid healthy economic momentum and strong liquidity, before slowing down in the aftermath of the acute drop in oil prices. In following 3-years, total assets just rose by 10% to USD 615 billion with an increase in deposit by similar percentage. Total claims on private and public sector rose by 11% to USD 372 billion and accounted for 86% of the total bank deposits.

Consolidated Figures of Commercial Banks – SAMA Report

US$ in million	2014	2015	2016	2017
Claims				
Public Sector	26,386	33,327	60,647	80,303
Private Sector	334,989	365,847	374,793	371,653
Deposits	420,154	427,938	431,203	431,750
Capital & Reserves	66,163	72,257	79,705	84,694
Profits (Cumulative)	10,709	11,382	10,763	11,647

Leasing in the Kingdom

The market for leasing in the Kingdom exists across a range of business sectors including manufacturing, oil and gas, construction and contracting, Hajj and tourism, agriculture, medical, transportation and trading. Businesses in these sectors find leasing attractive, not only because of its known advantages, but also because of its compatibility with the Islamic Sharia'h law.

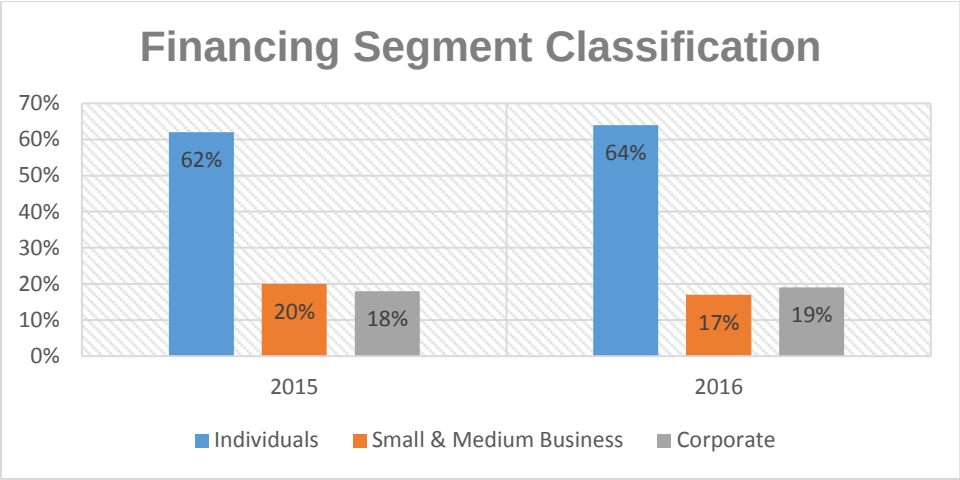
Until 2012, Leasing business was governed by contract law, treating the owner of the leased asset as Lessor and the lessee having the right of use in accordance with the terms of the lease contract. This legal framework remained applicable until endorsement of Real Estate Finance Law, Finance Lease Law and Finance Companies Control Law by the Council of Ministers in July 2012, to regulate finance lease and real estate mortgage business activities and finance companies. In 2013, SAMA also issued executive regulations for implementation of new laws to develop supervisory and regulatory framework with an objective to enhance stability of finance sector, fairness of the businesses and creating a competitive environment contributing towards improved finance services meeting the market needs.

Market Potential for Leasing & Other Financing Activities

As of 2017, SAMA issued licenses to 34 Finance Companies undertaking financing activities which include Leasing of productive assets, Real Estate Leasing, Auto-lease Financing to individuals, Financing to Small & Medium Businesses and Micro Financing.

	2013	*2014*	*2015*	*2016*
Total Number of Licensed Companies	**3**	**18**	**30**	**34**
Real Estate Finance Companies	2	5	6	6
Non Real Estate Finance Companies	1	13	24	28
Consolidated Capital (million US $)	**440**	**1,974**	**3,000**	**3,325**

Total Financial Assets of Financing Companies were US$ 8,347 million as at end of 2016, showing an increase of 10% as compared with 2015, while net financing during the year 2016 was US $ 15 billion as compared with US $ 14 billion in 2015, having a composition of 24:76 for Real Estate and Non-Real Estate Financing.



Geographical Classification: Central regions had the biggest share of Finance Companies services with 52% (2015: 53%), followed by Western Region at 23% (2015: 23%) and Eastern Region by 17% (2015: 17%). Finally, Northern Region together with Southern Region by nearly 8% (2015: 7%).

Consolidated Financial Statements of Financing Companies

	2015	2016		2015	2016
Cash & Cash Equivalents	1,460	1,369	Payable Amounts & Other Liabilities	1,804	1,578
Net Investment in Finance Contracts	2,693	2,375	Shor-term Loans	2,033	1,954
Other Current Asset	329	914			
Total Current Asset	4,482	4,658	**Total Current Liabilities**	3,838	3,532
Net Investment in Finance Contracts	5,060	5,263	Long-term Loans	1,938	1,987
Other Long-term Asset	466	467	Other Long-term Liabilities	251	202
Total Long-term Asset	5,527	5,730	**Total Long-term Liabilities**	2,190	2,189
			Total Liabilities	6,027	5,721
			Paid capital	2,760	3,325
			Reserves	192	224
			Retained Earnings	1,029	1,117
			Total Equity	3,981	4,667
Total Asset	10,008	10,388	**Total Liabilities**	10,008	10,388

Below are the fundamental financial numbers and financial ratios for the year 2015 & 2016 classified with respect to financing activity

	2015			2016		
	Non-RE	**RE**	**Total**	**Non-RE**	**RE**	**Total**
Total Asset	27,517	9,641	37,158	27,673	11,282	38,955
Equity	11,184	3,636	14,820	12,865	4,634	17,499
Net Profit	960	260	1,220	674	197	871
ROA	3.50%	2.70%	3.30%	2.40%	1.70%	2.20%
ROE	8.60%	7.10%	8.20%	5.20%	4.20%	5%

Given the certainty that the leasing market in the Kingdom is the biggest in the region and Gross Capital Formation running into many billions of dollars (even in deteriorated state), assessment of growth potential can be done on the basis of following

- Maintenance of large infrastructure developed over the past decade
- Untapped potential areas / cities, where the leasing services are relatively scarce
- Potential demand available for specialized products like aircraft finance, commercial vehicle` operating lease, auto lease, commercial and housing finance

Key Market Challenges

Debt Enforcement Mechanism	Besides having title to the lease assets, Financing companies obtains promissory note from the authorized signatory, major shareholder or owner of the business for payment of exposure amount. However, since debt enforcement mechanism is weak, it takes a long to time recover the money through legal means.
	Enforecement of Bankrupcy law and Incorporation of Contract Registry would improve the situation
Zakat & Tax	The International Accounting Standards require leasing companies to record rent-receivables (the net investment in finance leases) in its books of accounts rather than the assets that are being owned & leased by the leasing companies. The Department of Zakat and Income Tax ("DZIT") does not recognize such treatment and, therefore, does not allow a deduction of the net investment in finance leases in the Zakat/ Tax calculation. Similarly, provision for bad debts is also not allowed to leasing companies by DZIT whereas the same is allowed to the banks.
	Government has constituted a Committee with representation of Ministry of Finanace and SAMA to resolve the long outstanding issue. All the finance companies has submitted their concerns to the Committee along with proposed solution The Company has appealed against this treatment to the Preliminary Appeal Committee, the Appellate Committee for Zakat and Tax Appeals and the Board of Grievances.
Compliance with Anti-Money Laundering Laws and Regulation	Financing companies are primarily dealing with Small and Medium sized organizations and most of the companies in the segment are not much organized due to their size and scale of operations. The Anti-money law and Regulations prohibits collection of any payment in cash and requires acceptance of payment only from the beneficiary. Financing companies finds it difficult to comply with the requirements especially when it comes to collection of overdue amounts from defaulters or adjustment of payment received from third party on behalf of customer.
	While financing companies are trying to comply with the requirements of Anti-money Laundering laws and regulations, it should be acknowledged that controls and processes are always designed in accordance with the size and scale of operation. Moreover, financing companies neither take deposits from customers nor offer electronic transfer of funds, therefore are exposed to limited risk of money-laundering, therefore Anti-money Laundering laws and regulations applicable for banking companies should be tailored to risks involved and size and scale of operations of financing companies.

Repossession of Assets for Default Cases	Financing Companies provides lease facility to small, medium and large enterprises for assets like Vehicles, Machinery, equipment and Real Estate. Under the lease contract, Financier remains the legal owner of the asset, till payment of all amounts due under the contract. If a lessee defaults on payment of rentals beyond certain number of days, Financier has a right to repossess and sell the asset in the market to recover its exposure. However, Ministry of Interior has recently restricted repossession of assets under default only through Courts. The Courts, which were supposed to appoint repossession agencies, are not ready with the infrastructure as no one applied for establishment of such agency to the court; therefore the matter is neither here nor there.
	Alternate measures should be taken by the Ministry of Interior for the transition period
Saudization	Due to Saudization requirements, there is high demand for good Saudi resouce, which inturn has put pressure on salary cost and increased staff turnover.