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MARKET INSIGHT

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SAUDI ARAMCO IPO

Saudi Arabia announced its intention to sell 5% of its national oil & gas company Aramco, which has a value estimated by the government of USD 2 trillion. This estimation is equivalent to two thirds of the cumulative market capitalisation of all of the companies listed on the London stock exchange and would price Aramco at more than double the value of Apple. If the sale is carried out, it could represent the heaviest market cap ever, once it reaches approximately USD 100 billion and would also provide an insight into the operational structure of one of the most closed and secretive companies in the world.

The decision to sell a stake in Aramco is part of a plan hatched by Crown Prince Mohammed bin Salman (MBS) to form one of the largest sovereign funds in the world and reduce the kingdom's dependence on oil & gas. In reality, the move is motivated more by the fact that the kingdom needs to reduce its budget deficit by USD 83 billion, which represents more than 10% of its 2016 gross domestic product.

In the context of its efforts to reduce its deficit, the government has scaled back subsidies and cut salaries in the public sector. As these initial measures have proved insufficient, the kingdom has decided to improve the economic efficiency of the state by diversifying its revenue sources by 2030, with oil currently accounting for almost 90% of its total revenue.

The Aramco privatisation will therefore represent the first stage in the rebalancing of the economy. By separating the company from the state, MBS effectively hopes to reduce the company's dependence on oil, whilst also raising capital to invest in new industries. Included is the tech sector, where it plans to invest USD 45 billion in the Softbank Vision Fund, and the healthcare and leisure & tourism sectors.

Although the privatisation of the national flagship company is a determining factor in this process, there are a number of potential pitfalls. The company has become a conglomerate involved in far broader-ranging business lines than its energy interests, including road building and stadium construction, and the spinoff of these peripheral activities will be a complexed process which is nonetheless indispensable to enable investors to focus on the oil & gas potential harboured by Aramco.

It will also be difficult to convince the market of the announced valuation of USD 2 trillion as Aramco has released only scant financial information and certain data is not included within its annual report, notably group sales and earnings. Furthermore, the complex corporate structure and the company's unique central role in the kingdom, along with legal issues associated with the planned IPO, are just some of the difficulties facing the Saudi authorities ahead of a listing on the international markets. Analysts at Sanford C. Bernstein & Co. and Rystad Energy AS are forecasting a valuation that is broadly less than half of this figure, without even broaching the question of the real depth of the oil reserves hidden under the Saudi desert sands.

The extent of the oil reserves that Aramco claims to control is a fundamental question to be resolved. Aramco will have to control all of the 261 billion barrels of reserves announced by the state in order to obtain the maximum target valuation. The repeated affirmation by the kingdom that a USD 2 trillion valuation is justified implies that it plans to include all of these oil reserves on its balance sheet. The 8.43 billion cubic meters of natural gas, equivalent to 49 billion barrels of oil, will most likely be included as well.

The limited access to its oil represents another drawback to an IPO at the announced price. During previous oil company privatisations such as the Norwegian group Statoil, the government had authorised foreign competitors to exploit oil wells within the country and also own certain parts of the Norwegian continental plateau. This approach enabled investors to gain a more precise idea of Statoil's performances compared to its international peers and made it easier to check the size of the oil reserves. In contrast, since the nationalisation of this industry in 1980, foreign oil companies have enjoyed only limited access to Saudi oil via joint ventures or by other means.

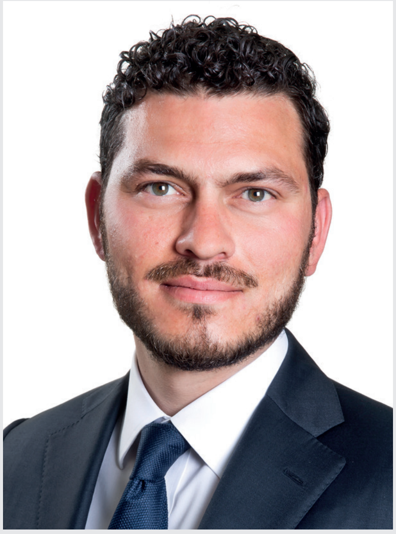
Furthermore, certain hypotheses indicate that Saudi Arabia will only partially privatise Aramco, notably its refining business, in order to keep most of the company out of the public eye. However, according to our analysis, this will not be the case. The IPO should concern the entire company, including oil production and the downstream refining business and chemical processing. Regardless of the quantity of oil & gas under its control, the market will consider the company's earnings to be a more important factor than its assets and the level of earnings will depend on two factors, i.e. the oil price and tax cuts. Last March, a royal decree lowered the tax rate in the oil & gas sector. For Aramco, this measure reduced its tax rate from 85 to 50%, thus adding to its appeal.

The stock exchange chosen for the IPO could also have an impact on company valuation. The New York and London stock exchanges are in the front line for the international issue, although Hong Kong would also like to participate. The US, which boasts the largest financial market in the world, and London, which is more internationally focused, appear to be the most attractive candidates. However, both of these venues present entry barriers. While many multinational commodities companies are already listed on the London exchange, several of the rules may prove dissuasive for Aramco. The UK stock exchange notably obliges all companies to list 25% of their securities, whereas Aramco plans to sell only 5% of its capital. Aramco should therefore benefit from an exceptional measure to enter this market. Meanwhile, a listing on the New York exchange would present another type of challenge. In September 2017, the US Congress overruled a presidential veto in order to adopt the Justice Against Sponsors of Terrorism Act, which enables US citizens to file proceedings against states if they consider themselves to be threatened by terrorists in a specific country. Since the adoption of this law, proceedings have already been initiated against Saudi Arabia due to the involvement of Saudi citizens in the 11th September terrorist attacks. As the Saudi government is exposed to the risk of judicial proceedings, a listing on the New York stock exchange would therefore incur major risks for investors.

Lastly, fears relating to sovereign risk in the market could also have a negative impact on the targeted USD 2 trillion valuation and the Saudi authorities must remain aware of this fact.

In all likelihood, the IPO will certainly not be finalised before 2019. The company is also considering a private securities placement among other sovereign funds, like China.

A Saudi Aramco deal may appear to be of an unreasonably enormous scale. However, it is perfectly feasible if the necessary information is made readily available to investors. Obtaining the optimum valuation for the kingdom's flagship remains uncertain. For Saudi Arabia, achieving this target may well come up against a major challenge, i.e. the authorities' willingness to share the kingdom's national oil activities with the inquisitive and sometimes critical wider world.



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