جدوى للإستثمار
Jadwa Investment

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Monthly Bulletin

Feature: TASI fairly valued and poised to rise

After a thorough examination of new company earnings data we have revised our outlook for the stock market. We now put fair value for the Tadawul all-share index (TASI) at 10,000, slightly above its current level. We expect the TASI to overshoot its fair value and end the year at around 12,000, implying a gain of just over 20 percent from its current level.

12,000 by the end of the year

The key factors supporting this upgrade are:

- **Better than expected earnings growth in 2007 and the first quarter of 2008:** At 21.5 percent, 2007 earnings growth outside the banking sector was above our expectations. Results for the first quarter were also slightly better than we had anticipated.

- **Improved economic conditions:** Since our December report it has become clear that oil prices will be higher and interest rates lower than we had anticipated. Both of these should help improve the financial performance of listed companies.

- **Inflation:** Earnings are stated in nominal terms so the upward revision to our average inflation forecast for 2008 (from 4.5 percent in December to 8.2 percent currently) means that earnings will be higher than previously expected.

Earnings growth should be strongest in the real estate and building and construction sectors, as strong domestic demand means that companies in these sectors can increase profit margins. We expect earnings to contract in the insurance sector, as dominant provider Tawuniya announced a sharp decline in earnings in the first quarter owing to losses on its investment portfolio. Energy and utilities should record low earnings growth as companies in this sector will face rising costs, but in the case of Saudi Electricity (which dominates the sector) will be unable to pass these on to consumers as the prices they charged are fixed.

Economy in brief: Commercial bank reserve requirements were raised for the fourth time since November on May 3. SAMA adjusts reserve requirements to try to absorb the liquidity generated by lower interest rates. Previous moves have had little effect on credit growth, but we think that the combined effect of two recent rises should restrain the growth in money supply, though not by enough to have a material impact on inflation.

Oil market in brief: Oil prices have continued to hit all-time highs. A promised increase in production by Saudi Arabia has had little effect on prices and looks unlikely to be followed by any other Opec members prior to their meeting in September.

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In our previous market call “Too far, too fast” (see our December *Monthly Bulletin*) we put fair value for the TASI at 8,500 and projected an end-year level of 10,000, based on earnings growth of 15 percent. At the time we issued that report the TASI was soaring through 11,000. Subsequently the market fell back in January and has since generally traded in a range between 9,000 and 10,000.

Poised for steady gains

We have re-examined our forecast with the benefit of earnings data for the whole of 2007 and the first quarter of this year. Earnings growth in 2007 was 12.7 percent, but this was distorted by the banking sector. Bank earnings contracted by 22.8 percent owing to lower stock market-related income (the value of shares traded declined by 51 percent last year compared with 2006). Excluding the banks, earnings growth was a much healthier 21.5 percent.

Based on 2007 earnings, the price-to-earnings ratio for the TASI on May 20 was 23.1, compared with 26.6 at the end of last year. This still looks relatively expensive compared to many global and regional markets (although the Brazilian and Russian stock markets are dominated by mining and energy companies, which seem around the peak of their earnings cycles, while in India valuations have improved following a 20 percent fall in share prices so far this year). Nonetheless, we believe that Saudi companies have a strong earnings potential and can support a P/E ratio close to this level.

Comparative valuations

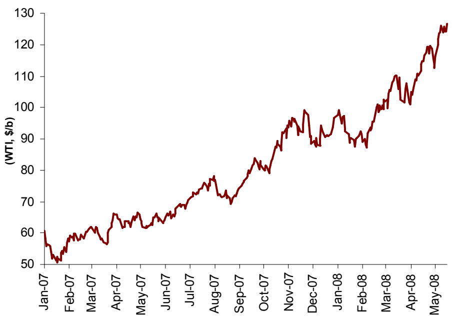
Market	P/E ratio
Brazil	17.2
China	26.7
Dubai	12.2
Korea	14.9
Kuwait	17.0
India	20.9
Russia	13.3
Saudi Arabia	**23.1**
US (S&P 500)	16.6

First quarter 2008 earnings data was again distorted by the financial sector. Based on the data available, we estimate that first quarter earnings growth was 10.6 percent. Excluding the banks and Tawuniya (formerly the National Company for Cooperative Insurance), which was hit by sub-prime-related write-offs, earnings growth was 16.3 percent. (Note that we also exclude from our analysis all of the new, and largely loss-making, insurance companies).

Earnings growth in the first quarter was fastest in the building and construction sector, at just over 30 percent, as high demand has allowed companies in this sector to increase margins. Cement producers have also benefited from the construction boom and recorded the next strongest rate of earnings growth, at 28 percent. Earnings growth in the agricultural sector also exceeded 25 percent as a result of strong performance by dairy, Almarai, and food processor, Savola (these companies were in the Industrial sector under the old market classification).

We have used the first quarter numbers to help determine our projections for earnings growth for the whole of 2008. Based on an examination of each of the sectors we have increased our earnings growth forecast for the market from 15 percent to 19.6 percent. The key factors supporting this upgrade are:

Oil prices continue to soar



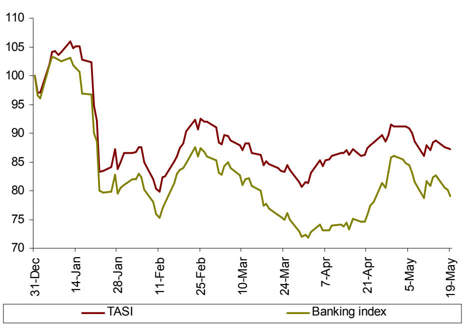
- **Better than expected earnings growth in 2007 and the first quarter of 2008:** At 21.5 percent, 2007 earnings growth outside the banking sector was above our expectations. Results for the first quarter were also slightly better than we had anticipated.

- **Improved economic conditions:** Since our December report it has become clear that oil prices will be higher and interest rates lower than we had anticipated. Both of these should help improve the financial performance of listed companies.

- **Inflation:** Earnings are stated in nominal terms so the upward revision to our average inflation forecast for 2008 (from 4.5 percent in December to 8.2 percent currently) means that earnings will be higher than previously expected.

Rapidly rising real estate prices and strong demand mean that we expect the building and construction, real estate and cement sectors to record the highest rate of earnings growth. Performance is expected to be worst in the insurance sector, where dominant provider Tawuniya announced a sharp decline in earnings in the first quarter owing to losses on its investment portfolio. A breakdown by sector of our earnings projections is below.

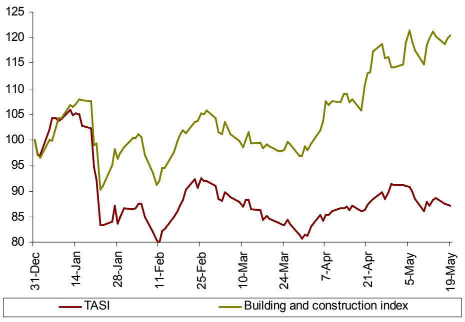
Banks have underperformed



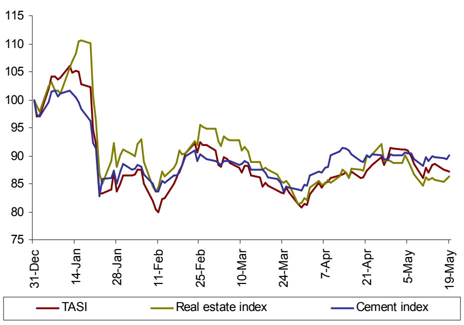
Banks: Earnings growth for the banks is expected to be fairly weak again this year, at 10 percent. Write-downs of assets devalued by the global credit crunch have so far been reasonably modest, but further balance sheet adjustments remain a possibility. Greater competition from the new investment companies will squeeze margins. The recent tightening of commercial bank reserve requirements, which reduces the funds banks have available to lend, will also restrain profitability.

Petrochemicals: Rapidly rising engineering, procurement and construction costs and falling, albeit still high, product prices stemming from a global increase in production capacity will hold down earnings growth in the petrochemical sector to 10 percent.

Strong construction earnings expected



Good earnings for cement and real estate



Multi-investment: As holding companies with diversified interests, the performance of most of the multi-investment companies should broadly mirror that of the whole market. However, Kingdom Holdings, by far the largest company in the sector, will be affected by the weak global economy because of its large portfolio of foreign assets, so we are forecasting earnings growth of 15 percent for the sector.

Building and construction: Very strong demand for real estate will allow building and construction companies not only to pass on their rising costs to final consumers, but also to increase margins. We expect this sector to record earnings growth of 35 percent in 2008.

Energy and utilities: This sector is dominated by Saudi Electricity, which will find it tough to increase earnings in 2008, as it has limited pricing flexibility through which to pass on rising costs. Earnings growth is forecast at just 5 percent.

Industrial investment: This sector contains a broad range of industries that are likely to benefit from the strong growth in the non-oil economy. We predict earnings growth of 20 percent for the sector.

Earnings growth projections

Sector	EPS growth 2008	P/E based on 2008 earnings
Banks	10	18.5
Petrochemicals & industries	10	31.8
Multi-investment	15	53.0
Building & construction	35	17.6
Energy & utilities	5	18.0
Industrial investment	20	24.1
Cement	30	11.6
Real estate	35	18.3
Transport	15	22.4
Media & publishing	20	10.4
Hotels & tourism	10	47.5
Retail	15	20.7
Telecoms	5	13.2
Insurance	-15	11.1
Agriculture & food industries	15	26.8
TASI	**19.6**	**19.3**

Cement: Strong demand generated by the construction boom within the region will generate robust earnings growth for cement companies. Lower capital spending owing to the completion of sector-wide expansion projects should also support earnings growth of 30 percent.

Real estate: Real estate companies currently have considerable flexibility in setting prices given the very strong demand for property in the Kingdom. We project earnings growth in the sector of 35 percent.

Transport: National Shipping Company, which dominates the transport sector, is likely to experience a higher volume of traffic as both imports and exports pick up, but chartering rates for some of its fleet are declining. Low retail fuel prices will continue to support growth elsewhere in the sector and earnings growth is projected at 15 percent.

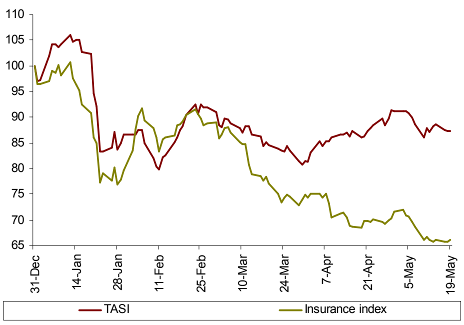
Media and publishing: Shortages of printers and advertizing firms within the Kingdom will allow firms in this sector to expand margins, so we forecast earnings growth of 20 percent.

Hotels and tourism: Greater availability of low cost airlines and the fall in the value of the riyal may encourage more tourist travel within the Kingdom, while the continued strength of the economy will stimulate more business travel. However, the two listed hotels and tourism companies have not proved adept at exploiting growth opportunities so we expect earnings growth of 10 percent for the sector.

Retail: Inflation is eroding consumers' spending power, particularly for those on lower incomes. However, the larger listed retailers are more reliant on middle income consumers and will therefore continue to benefit from the strong economic conditions and rising population growth, resulting in earnings growth of 15 percent for the sector.

Telecoms: New competition in the telecoms sector, particularly from Saudi Zain in the provision of mobile services, is expected to force existing operators to cut prices and enhance their services. While the overall number of mobile phone subscribers should continue to rise (mobile phone penetration is low on a regional basis) earnings growth for the sector is forecast at 5 percent.

Insurance hit by poor results



Insurance: Tawuniya's earnings fell by 81 percent in the first quarter this year compared to the same period of last year because of write-offs related to investments affected by the sub-prime crisis. While new legislation is encouraging much a greater take up of insurance, the company will be affected by competition from the new insurance companies. We expect earnings to decline by around 15 percent this year (note that we do not include the newly listed insurance companies in our analysis).

Agriculture and food: While prices of some basic foodstuffs are controlled by the government, this sector will clearly benefit from the surge in global and local food prices (according to IMF food prices were 46 percent higher in April than one year earlier). The continued reduction of subsidies will, however, limited earnings growth in agriculture and food processing sector to 15 percent.

Applying our 2008 earnings assumptions to current share prices generates a forward P/E of 19.3, which we think is around fair value. We also considered the P/E to earnings growth (PEG) ratio. This examines how much an investor is paying for one riyal of earnings growth. A PEG ratio of 1 indicates fair value, between 0-1 is considered undervalued and greater than 1 or negative is overvalued.

Taking this approach reaffirms our view that the market is currently around fair value and supports our conclusions about the performance of individual sectors. Construction, cement, real estate, and media appear to offer the best value. Investors should be cautious towards the hotel and tourism, multi-investment and utilities sectors, where valuations appear stretched.

P/E to earnings growth (PEG) ratio

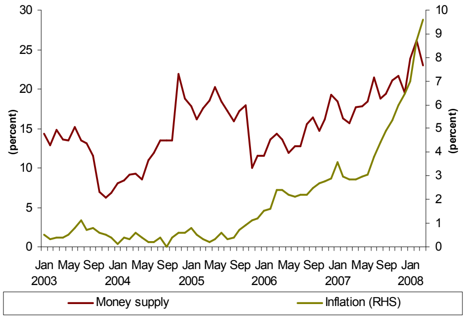
Sector	PEG
Banks	2.0
Petrochemicals & industries	3.5
Multi-investment	4.1
Building & construction	0.7
Energy & utilities	3.8
Industrial investment	1.4
Cement	0.5
Real estate	0.7
Transport	1.7
Media & publishing	0.6
Hotels & tourism	5.2
Retail	1.6
Telecoms	2.8
Insurance	-0.6
Agriculture & food industries	2.1
TASI	1.2

We believe that with a forward P/E ratio of 19.3, earnings growth of 19.6 percent, and a PEG ratio of 1.2, the TASI is currently fairly valued at 10,000. In light of strong economic performance, high oil prices, robust earnings expectations, the abundance of liquidity and a strong IPO pipeline (which tends to add to optimism), we think the TASI is poised to overshoot fair value as this year progresses. We therefore forecast the TASI to end the year near to 12,000.

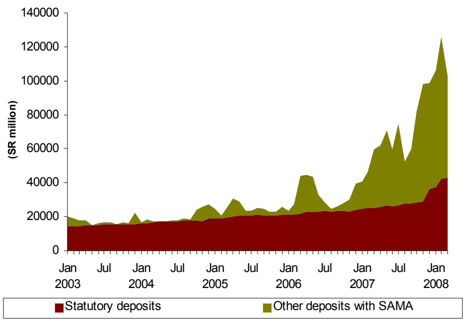
Economy watch

The impact of higher reserve requirements

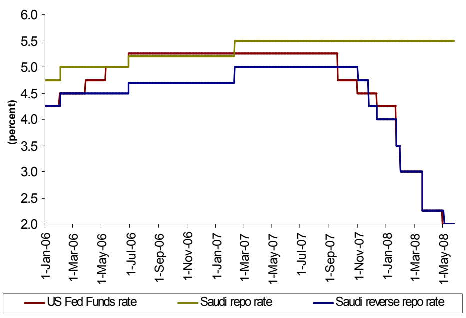
Money supply has helped push up inflation



Banks reserves well above requirement



Rate cuts may be coming to an end



Commercial bank reserve requirements were raised for the fourth time since November on May 3. SAMA, the central bank, adjusts reserve requirements to try to absorb the liquidity generated by lower interest rates. Previous moves have had little effect on credit growth, but we think that the combined effect of two recent rises should restrain the growth in money supply, though not by enough to have a material impact on inflation.

After being held unchanged for 27 years, commercial bank reserve requirements have become one of the main tools that SAMA has used to offset the impact of lower interest rates. Increasing the reserve requirement raises the amount of money banks have to place as statutory deposits at the central bank, reducing the total they have available to lend and thereby slowing credit growth and ultimately inflation.

New data shows that the two earlier hikes in the reserve requirement for current accounts, which took it to 10 percent in January from 7 percent in November, had little effect. Commercial bank statutory deposits at SAMA rose to SR42.4 billion in February from SR28.8 billion in November, but banks were also able to increase other deposits at SAMA over this period by SR15.5 billion. Money supply growth fell to a three-month low of 23 percent in March, but private sector credit continued to rise and bank lending to the private sector as a proportion of total deposits was higher than before the reserve requirement was increased.

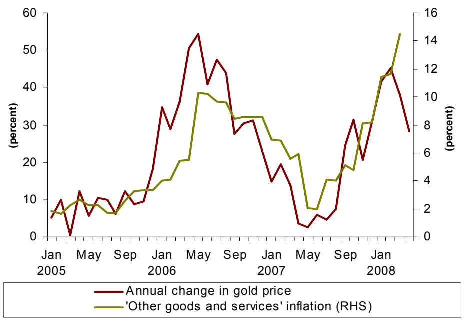
After a two percentage point increase in the reserve requirement for current accounts in April, on May 3 SAMA raised the reserve requirement for current accounts again, to 13 percent and for the first time lifted the reserve requirement for time and savings deposits, to 4 percent from 2 percent. These two moves will require banks to lift their statutory reserves by SR16.1 billion (based on March data). Since November, banks have been required to set aside an additional SR25.1 billion as reserves, equivalent to 2.1 percent of total bank assets.

The sharper tightening of reserve requirements has come against a backdrop of slowing interest rate cuts. The reverse repo rate (the rate SAMA pays for deposits) was lowered for the first time since mid-March on May 3, to 2 percent from 2.25 percent. Futures markets are not pricing in any further cuts in the US Fed funds rate this year (SAMA is compelled to follow moves in the Fed funds rate to support the exchange rate peg). Nonetheless, interest rates will stay very low (well below zero in inflation-adjusted terms). We therefore think that the higher reserve requirements should restrain the growth in money supply, but are unlikely to slow it significantly.

Higher reserve requirements will eat into bank profits even if they do not impact materially on lending growth. This is because statutory reserves at SAMA do not earn interest, whereas other deposits receive interest based on the reverse repo rate. Banks will therefore need to increase the spread between lending and deposit rates in order to maintain profitability; raising the former would also help to contain money supply growth.

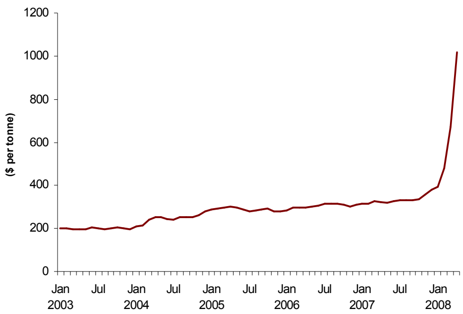
In brief: Economy

Gold price adds to inflationary pressure



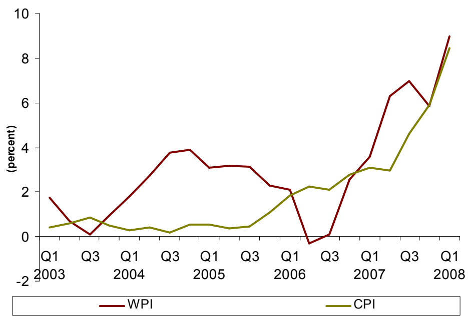
Inflation has continued its rapid ascent. Year-on-year inflation hit 9.6 percent in March from 8.7 percent in February. Rents remained the main source of inflation, up by 15.8 percent, but food prices were taken by inflation from 'other expenses and services', which jumped to 14.5 percent. This category of the cost of living index includes personal hygiene items, hotels, administrative fees (many of which were cut in January) and jewelry. We think that the jump is the result of higher jewelry prices, as these items are heavily influenced by international gold and silver prices. The graph to the left shows the strong relationship between inflation for 'other expenses and services' and the annual change in the gold price. Gold prices eased in April, but have picked up again so far in May; it is likely that inflation for 'other expenses and services' will do the same.

Massive growth in rice price continues



Food price inflation climbed to 12.2 percent in March, from 11.2 percent in February, and is likely to have risen further in April. We included a graph of the rice price in the last *Monthly Bulletin*, but have updated it to illustrate just how far rice prices have surged recently. A combination of strong demand, dwindling stocks, hoarding and export restraints pushed rice prices up by 51 percent in April, to triple the level of October 2007. In March, India, the main source of rice imports into Saudi Arabia, banned the export of all types of rice other than basmati, for which it introduced a $200 per tonne export duty. To help shield the Kingdom from international rice prices, Saudi officials are discussing investing in rice farms in Thailand.

Wholesale prices also climbing



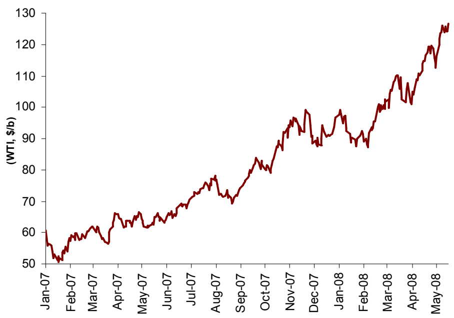
Wholesale price inflation has also surged, standing at 9 percent in the first quarter compared to 5.8 percent in the final quarter of last year. Gold prices are again one of the main factors behind this rise; they account for almost all of the 'other commodities' component of the index, which recorded the fastest growth rate of 36.2 percent year-on-year. Chemicals and related products recorded the next highest rate of growth, at 21.5 percent. Rises in wholesale prices have not been fully reflected in consumer prices in recent years, a sign that retailers have been squeezing their margins, so it is notable that the gap between the two measures of inflation has virtually disappeared over the last two quarters.

Consumer spending holding up

It seems that **inflation has not yet had much impact on consumer spending**. Retail sales figures are not published, but there is data on point of sale transactions. This shows that growth in consumer spending (measured as the three-month average of the average value of transactions per point of sale terminal) has remained strong over the first quarter of this year. It appears that consumer spending was heavily affected by the stock market; rather than spending, consumers put most of their spare funds into the market from mid-2004 and then cut back on spending further after the crash of early 2006. Based on the chart to the left, it appears that consumer spending is now growing at its fastest rate since early 2003.

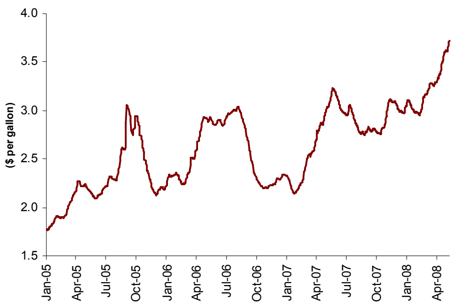
In brief: Oil market

Oil prices continue to soar



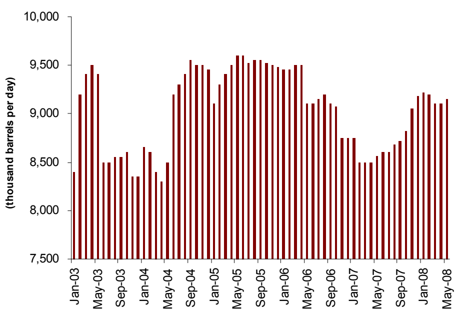
Oil prices have continued to hit new all-time highs, reaching $132 per barrel on May 21. The market remains concerned about an imbalance between demand and supply. Higher prices and the slowing global economy have continued to lower projections for demand, with the International Energy Agency trimming its forecast for global demand growth in 2008 by over 20 percent in May to 1.03 million barrels per day (global demand growth for 2008 was projected at 2.1 million b/d last December). However, there is little sign of much fresh supply entering the market beyond an additional 300,000 b/d from Saudi Arabia (see below). It is notable that the demand for oil as a hedge against dollar weakness has been less of a factor recently; the dollar has strengthened since the middle of April, while oil prices have climbed by $10 per barrel.

US consumers starting to feel the pinch
(price of US regular gasoline)



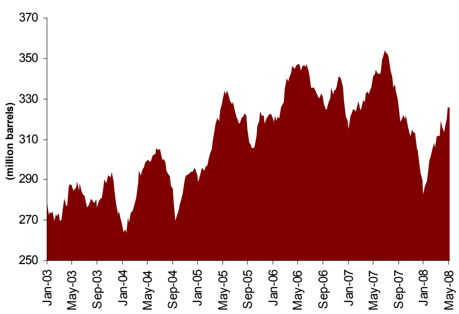
Consumers have been sheltered from the full impact of higher oil prices by price controls in many emerging markets, tax in Europe and refiners absorbing the higher costs in the US. We think that **lower consumption in the US will be the trigger for the downturn in oil prices** that we anticipate over the remainder of the year. Low margins mean that US refiners are passing on more of the rise in oil prices to consumers and the average price of regular gasoline in the US has risen by 13 percent since the end of March. Higher gasoline prices have already encouraged greater car pooling and lower SUV sales and are soon likely to cause a sharper slowdown in US consumption.

Saudi production set to increase



Saudi Arabia decided to lift oil production by 300,000 b/d in June, to around 9.45 million b/d. The increase was announced during a visit by the US President, George Bush, who has been pushing for greater oil production to bring down prices. Current high prices are also a concern for the Saudis, as they threaten consumption and prompt investment in alternative energy sources. However, Saudi Arabia's current spare capacity consists of heavy sour crude that requires complex and expensive refining, which makes it less desirable than light sweet crudes, for which there is virtually no excess global capacity. Unless a buyer has been found for the new crude it would only add to global inventories and have little impact on prices. The announcement of the increase in production barely impacted upon international oil prices.

Stocks are rising
(EIA weekly crude stocks)



The rise in Saudi output is likely to be the only new increment to production from Opec members over the summer. Several Opec members have said that the market is well supplied and that while discussions are ongoing, **there will not be a formal Opec meeting prior to the next scheduled meeting in September**. The recent rise in stocks supports Opec's view of the market. US stocks have been on an upward trend since the turn of the year and in the first week in May were 12.5 percent higher than in early January.

Key data

	2002	2003	2004	2005	2006	2007E	2008F	2009F	2010F
Nominal GDP									
(SR billion)	707.1	804.6	938.8	1182.5	1318.0	1414.0	1712.2	1712.7	1863.1
($ billion)	188.6	214.6	250.3	315.3	351.5	377.1	456.6	456.7	496.8
(% change)	3.0	13.8	16.7	26.0	11.5	7.3	22.1	0.0	8.8
Real GDP (% change)									
Oil	-7.5	17.2	6.7	7.8	0.2	-1.5	4.0	5.0	1.0
Non-oil private sector	4.1	3.9	5.3	5.8	6.4	5.9	7.6	8.0	7.8
Government	2.9	3.1	3.1	4.0	6.1	4.3	5.0	5.0	4.5
Total	0.1	7.7	5.3	6.1	4.3	3.5	5.5	6.4	5.0
Oil indicators (average)									
WTI ($/b)	26.2	31.1	41.5	56.7	66.1	72.3	90.0	76.0	85.0
Saudi ($/b)	0.2	0.4	0.7	-0.6	-0.5	68.1	85.0	72.0	79.5
Production (million b/d)	7.5	8.8	9.0	9.5	9.2	8.8	9.2	9.5	9.6
Budgetary indicators (SR billion)									
Government revenue	213	293	392	564	674	622	792	706	780
Government expenditure	234	257	285	346	393	443	532	611	685
Budget balance	-21	36	107	218	280	179	260	95	95
(% GDP)	-2.9	4.5	11.4	18.4	21.3	12.6	15.2	5.5	5.1
Domestic debt	660	660	614	475	366	267	250	230	240
(% GDP)	93.3	82.0	65.4	40.2	27.8	18.9	14.6	13.4	12.9
Monetary indicators (average)									
Inflation (% change)	0.2	0.6	0.3	0.7	2.3	4.1	8.2	6.2	5.0
SAMA lending rate (%, year end)	2.00	1.75	2.50	4.75	5.20	5.50	5.50	5.50	5.50
External trade indicators ($ billion)									
Oil export revenues	63.6	82.0	110.4	161.1	187.7	201.2	260.5	227.8	257.1
Total export revenues	72.3	93.0	125.7	180.1	210.5	229.7	290.2	261.0	292.9
Imports	29.6	33.9	41.1	54.6	63.8	81.5	106.0	129.3	153.9
Trade balance	42.6	59.1	84.6	125.5	146.6	148.2	184.2	131.7	139.0
Current account balance	11.9	28.0	51.9	90.0	98.9	91.8	126.7	79.2	93.5
(% GDP)	6.3	13.1	20.7	28.5	28.1	24.3	27.8	17.3	18.8
Official foreign assets	73.3	97.1	127.9	195.5	273.4	359.8	477.7	553.7	644.2
Social and demographic									
Population (million)	21.5	22.0	22.5	23.1	23.7	24.5	25.3	26.1	26.9
Unemployment (male, 15+, %)	7.6	8.2	8.5	8.8	9.1	9.0	8.8	8.5	8.2
GDP per capita ($)	8773	9745	11112	13640	14843	15394	18039	17483	18451

Sources: Jadwa forecasts for 2007 to 2010. Saudi Arabian Monetary Agency for GDP, monetary and external trade indicators. Ministry of Finance for budgetary indicators. Central Department of Statistics and Jadwa estimates for oil, social and demographic indicators.

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