Market Insights & Strategy

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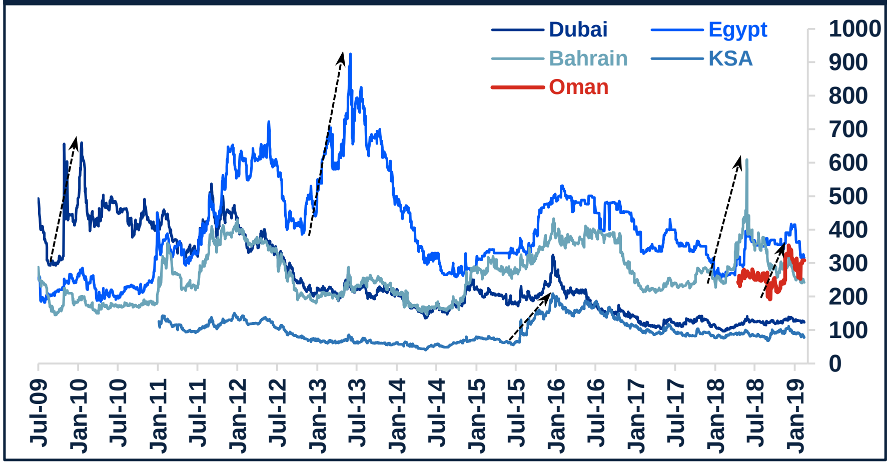
Oman
Pressure to Reform

Last year investors were raising concerns over the fiscal position in Bahrain and since then we have seen strong demand again for the Gulf Kingdom's credit. Now it seems the investors are fretting over Oman's admittedly weak financial position. However, as was the case with Bahrain we believe that these fears have become somewhat overblown, at least that is in the near term.

How bad is the situation for Oman?

Investors' concern pushed Oman's 5-year CDS as high as 350bps towards the end of 2018, from the sub-250bps level seen in October. However, a closer analysis of the sudden blip seen in Oman's credit spreads, on a relative value basis (as shown in the below chart and table), shows us that the intensity of the spread gyration was relatively low compared to the widening seen for some of its peer sovereigns when they were going through some economic distress and hence suffered negative investor sentiment. For example, when Dubai experienced a credit crisis back in 2009, its CDS spread shot up to 650bps from the pre-crisis level of 300bps. Similarly, when Egypt was experiencing economic distress in 2012-13, investors pushed the CDS spread up by 130% to 925bps level. More recently, in Bahrain's crisis situation last year, CDS spreads jumped circa 150% to ~600bps. In Oman's case, however, the CDS blip was 'only' around 50% or a jump of circa 120bps, as compared to the 350bps, 525bps and 360bps blips seen for Dubai, Egypt and Bahrain respectively. Net net, while it appears that investors are indeed concerned by the weakening fiscal health of Oman, they aren't yet hitting the panic button in the way they reacted to the situations of other MENA sovereigns.

5-Year CDS spread in basis points



Source: Bloomberg; FAB

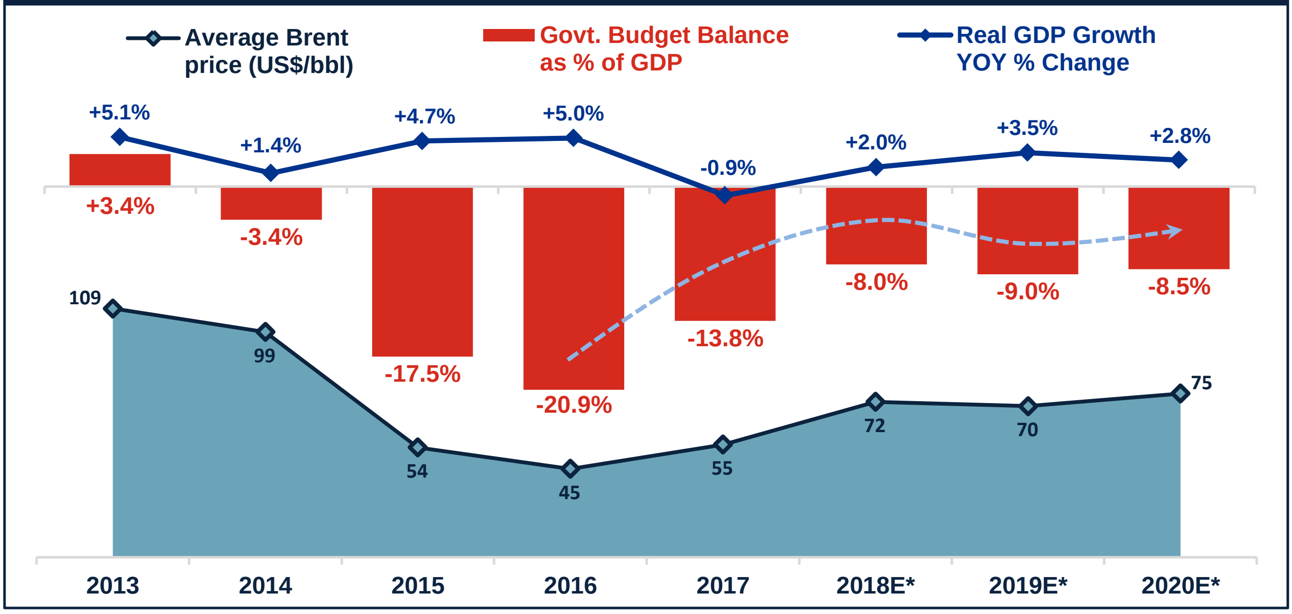
Background

Oman is the world's oldest independent Arab state and was considered to be a major regional trading centre in the early part of the 19th century, taking advantage of its strategic location and the seafaring expertise of its inhabitants. These attributes helped spread Omani influence both sides of the Arabian Peninsula, down the East coast of Africa and even across areas of present day Pakistan. During this time there were two Sultanates, one controlled by Muscat and one based in Zanzibar. In 1964 Zanzibar gained independence and was incorporated into the country now known as Tanzania. A few years later Oman's current ruler, Sultan Qaboos bin Said ascended to the throne and almost immediately set out to modernize his nation financed by the country's fledgling oil industry. As with most of the GCC states Oman continues to rely heavily on its energy sector to generate the bulk of government revenues. Thus the sharp drop in prices during 2014-16 had a significant impact on the country's coffers. (Please refer to the chart below)

Economic snapshot: Look beyond the deficit

The Omani economy performed reasonably well in 2018 with GDP forecast to have expanded by around 2%, underpinned by higher average oil and gas prices. The economy is now expected to expand by around 3.5% this year, before setting close to 3.0% in 2020 and 2021.

Oman's fiscal position vs Brent oil price



*Note: * FAB estimates; Source: IMF; Moody's; Oman Ministry of Finance; FAB*

This improving growth picture over the past year, together with increased hydrocarbon output, has helped to bolster public finances and export growth and in turn underpin our interpretation of the country's macroeconomic fundamentals.

Increased output from the Khazzan-Makarem gas field that began production in 2017, stronger fixed investment and the government's push to strengthen non-hydrocarbon output should support overall economic growth this year.

Moreover, as the Sultanate also actively pursues fiscal consolidation, we believe that the economy's fiscal position is steadily improving. From a macro perspective therefore it could be argued that financial markets' current concerns toward Oman are overly pessimistic.

Legacy reliance on oil & gas

While the government continues its efforts toward economic diversification, it is important to note that Oman is still heavily dependent on oil and gas resources, which tend to generate up to 85% of government revenue, depending on fluctuations in commodity prices.

Indeed, government revenue climbed by over a quarter last year compared to the same period in 2017 as the oil price recovered, which helped to fuel a reduction in the fiscal deficit of around 28%. Meanwhile, in January–September, merchandise exports also climbed by over a third year-on-year.

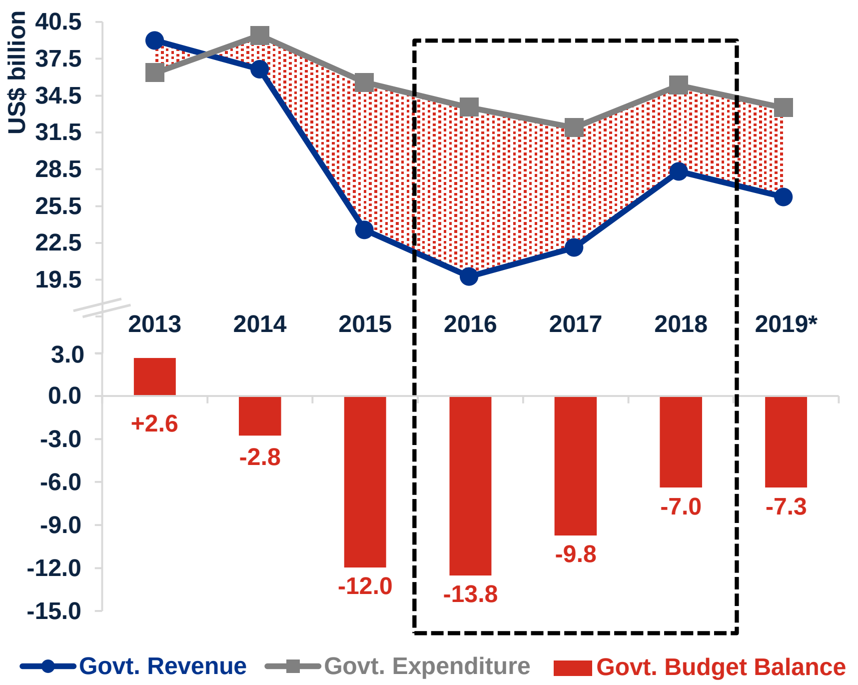
All of this has helped to keep foreign currency reserves at the central bank well supported, standing at \$17.4bn (OMR 6,686m) as of December 2018, up by \$1.3bn, as compared to \$16.1bn at the end of 2017.

Deficit overhang

Oman's macro position has come under the spotlight in recent months, with investor focus falling in particular on the country's onerous budget deficit. With the Sultanate's budget balance forecast to be in deficit this year by around 9% of GDP, the country's credit ratings have come under increasing scrutiny in recent months by the major ratings agencies (please refer to the Credit Outlook section below for further details).

The fiscal challenges facing the country are clear. In the recently released 2019 state budget, the Oman government projected spending this year to be OMR 12.9bn ($33.5bn), which would be a 5.14% decline from the OMR 13.6bn realized in 2018. Meanwhile though government revenues are forecast at OMR 10.1bn ($26.2bn) this year, based on an average oil price of $58 per barrel for the year, which would represent a decline of 7.34% over 2018 real reported revenues. As such expenditure continues to outpace revenue on a relative basis, thereby keeping the deficit elevated.

Oman is trying to control its budget deficit... but need to show more commitment



Oman managed to reduce its 2017 and 2018 fiscal deficit with the help of some fiscal reforms and higher oil price.

- **2017 revenues rose by 12% yoy supported by an increase in corporate income tax**
- **In 2018 higher oil prices boosted revenues by 28% yoy**

However, Oman needs to expedite its reform efforts to reduce expenditure further. For example, Oman on an average spent around 5% more than what it has been budgeting since 2016.

At the same time Oman has to focus more to diversify its sources of revenues for a sustainable fiscal position.

*Note * 2019 figures are budgeted figures while prior year figures are actual figures: Source: Oman Ministry of Finance; FAB*

The authorities have so far been able to fund the deficit without difficulty though, through international borrowing, with the budget also buoyed by the recent (modest) recovery in the oil price. Our forecast of an average annual (2019) oil price of $60-$65 for WTI and $70-$75 for Brent, coupled with anticipated moves by the government to cut expenditure and boost revenue, should be help to underpin the government's budget position over the coming months.

Aside from deficit concerns, on the positive side of the macro equation, as alluded to above, Oman's economy benefits from large oil and gas reserves, including the sizeable new gas field at Khazzan-Makarem. Moreover, the Sultanate also benefits from a clear geographical advantage, located between Asia and Africa – and adjacent to major international shipping routes.

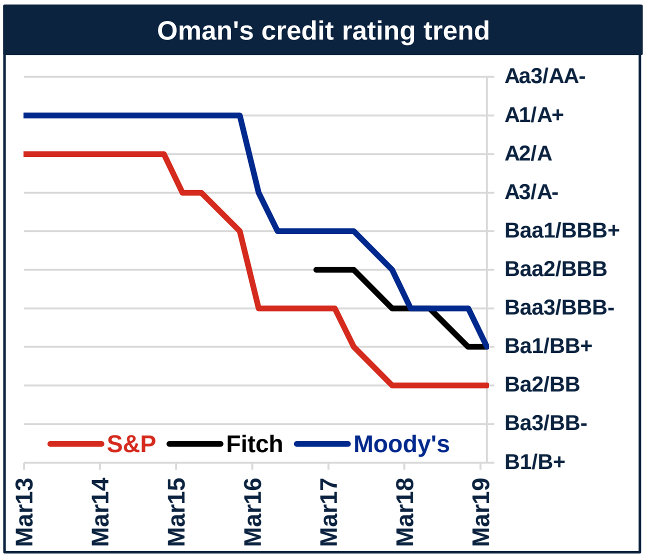
In our view this makes Oman a natural regional logistics and manufacturing hub. We note that the logistics sector of the Oman economy grew by 8% in 2018, more than double the rate of the overall economy, with the sector now employing over 83,000 people and accounting for 3.75% of the country's overall GDP.

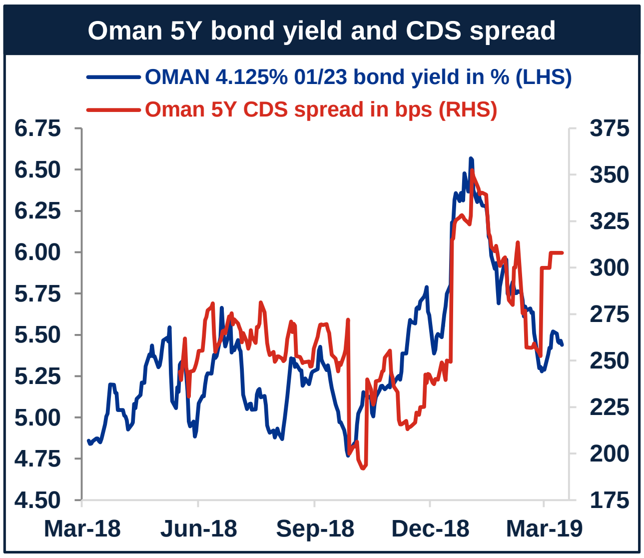
The authorities are seeking to leverage such advantages in order to diversify the economy and reduce its reliance on hydrocarbons production, particularly in light of the volatility seen in the oil price since the market correction during the 2014-2015 period. The consequent decline in oil revenue negatively affected economic growth in Oman, as well as the aforementioned government accounts and finances.

Credit outlook

Oman's sovereign credit spreads are still cheap on a relative value basis as we conjecture that the sovereign's credit health is not as precarious as it is perceived by the market at present. In March 2018, rating agency Moody's cut Oman's rating by one notch to Baa3 and assigned a negative outlook to the rating, for another possible downgrade, citing the sovereigns deteriorating fiscal position on account of lower oil revenues. S&P already had Oman in steady rating decline since February 2015 and in sub-investment grade territory (BB/Stable) since May 2017. Yields on Oman sovereign bonds started rising from October, as market was squarely focused on the expected rating downgrade from Moody's and started pricing Oman's credit risk similar to a sub-investment grade credit. However, investors were taken by surprise in December 2018 when Fitch Ratings decided to downgrade Oman from BBB- to BB+, though it has maintained a stable outlook on the sovereign before the negative rating action.

Following the Fitch downgrade, markets – or we would rather argue that the media – speculated that Oman is bracing for a Bahrain like credit crisis and need a similar bailout package from its wealthy neighbours. The significant spread widening in Oman's sovereign credit risk (bond and CDS spreads) seen during December was a knee-jerk reaction from investors, we would allude, with the 5-year CDS widening as high as 350 basis points and 2023 bond yield breaching 6.5% level. Since then, bond and CDS spreads have come off, but still trade wider than their peer credits.





Source: Bloomberg; FAB

Most recently, Moody's finally concluded its review on Oman on 5th March – having assigned a negative outlook a year earlier – and cut Oman's rating to Ba1 from Baa3. While the downgrade was expected for long, and been priced-in in the sovereign spreads, Moody's chosen to keep a "negative" outlook on the rating saying that the balance of risks to the Ba1 rating is skewed to the downside. The major downside risks that Moody's currently watching for a further downgrade are:

1. Any meaningful deterioration in Oman's international investors' willingness to finance the sovereigns large deficits at relatively low costs; and
2. A material erosion in Central Bank of Oman's foreign exchange reserves or liquid sovereign wealth fund assets

While we acknowledge that Oman is facing a structural fiscal problem, amid its high debt servicing burden, our base case scenario for Oman in the near-term is not for a default-like scenario or indeed the nation seeking a bailout from its GCC peers. In our opinion, Oman's credit metrics are still relatively strong compared to Bahrain's and hence command a BB level sub-investment grade rating. We would indeed argue that Oman's current credit metrics allow the sovereign to keep its head above water till 2020/21 as the Sultanate could meet its debt maturities from its internal resources and external funding. For example, Oman's foreign reserves (assets and bullion) stood at $17.4bn at the end of 2018, sufficient to service its external debt maturities this year which we estimate around $3.5bn, including interest payments.

Oman also has the option to withdraw assets from its sovereign wealth funds, namely, the State General Reserve Fund and Oman Investment Fund. According to the Sovereign Wealth Fund Institute, the combined assets of the above Omani funds are circa $24bn. We also believe that Oman still has access to international debt capital markets, albeit it would need to be willing to pay an incremental cost of funding, as we have seen recently in the case of other emerging market sovereign credits with sub-investment grade ratings.

Moreover, Oman has already initiated a strategy to address its short-term credit issue. As per a Bloomberg report dated 21st March, a senior government official acknowledged that they have a plan in place to cut down Oman's borrowing requirements this year by as much as 70%. This is in contrast to the government's earlier plan to raise around $6.2bn – 85% of 2019's budgeted deficit – from the debt capital market.

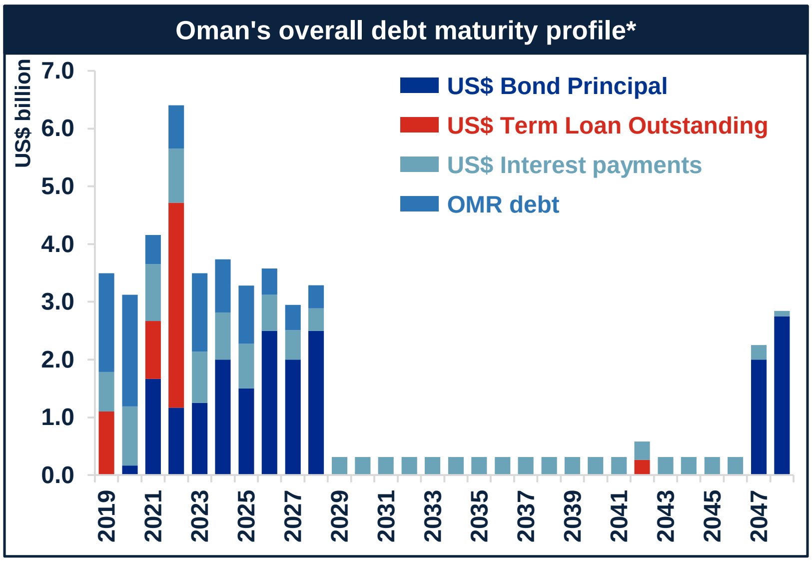
As per the latest funding strategy, Oman is likely to finance this year's $7.3bn budgeted deficit by

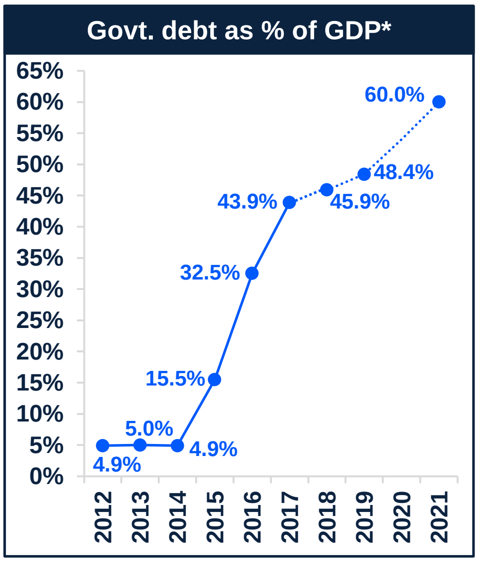
- tapping a $1.2bn loan backed by the World Bank's Multilateral Investment Guarantee Agency;
- raising debt of around $2-3bn through bonds and loans;
- While the rest of budget deficit (around $3-4bn) will be financed from the proceeds received from Oman Oil Company's stake sale of the Khazzan field and ownership transfer of some gas pipelines to Oman Gas Company.

The first two options, which should be relatively easy for Oman to secure, covers around 50% of the 2019 budgeted deficit. However, financing the remainder of the deficit, through stake sale/ownership transfers, involves some challenges in our opinion – such as risks around the valuation of the assets concerned, and indeed execution of such deals, including identifying the potential/suitable buyers especially as Oman is trying to monetise the assets this year. If Oman struggles to monetise the assets within the relatively short timeline it would most likely have to turn towards debt markets yet again. According to the Bloomberg article, the government official did acknowledge that any additional required funding beyond the above plan will come through domestic borrowing.

Government debt

Oman's debt servicing obligations through 2021 is around $3-to-4bn each year, including local debt maturities. If we exclude local debt, there is close to $2bn falling due this year with around $1bn to be repaid in 2020. We expect Oman's yearly fiscal deficit to average around $5bn in next five years, if the sovereign expedites its reform agenda. While we believe that Oman can manage its debt maturities for next two to three years, the sovereign faces a major challenge in 2022 when around $6.5bn of borrowings fall due, including interest obligations. For the next six years, on an average, the sovereign has debt servicing obligations of around $3.5bn each year. Any short-term (3-to-5-year tenor) debt refinancing of the expected budget deficit in next few years would only elevate the yearly debt service burden for Oman, raising its Debt to GDP ratio in the medium term, creating further pressure on the sovereign credit ratings.





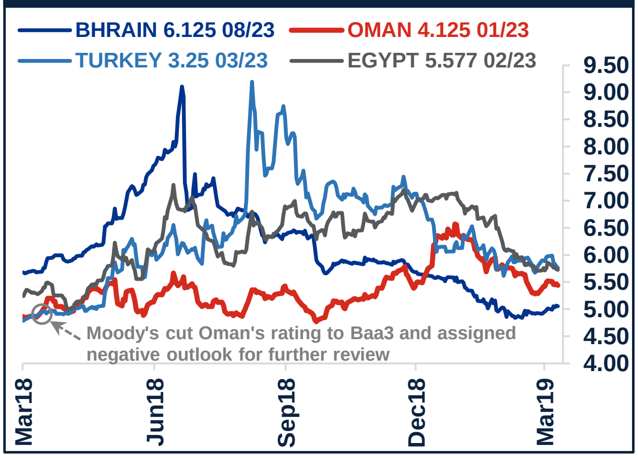
*Note: * Govt. debt as % of GDP is Moody's estimate and forecast (2018 to 2020); * Overall debt includes sovereign guaranteed debt obligations of govt. entities; Source: Bloomberg; FAB*

The sovereign thus needs to issue longer-tenor debt on a regular basis, in order to extend its debt maturity profile over time, which in our opinion is the major challenge for Oman at present. A rising global interest rate environment and the sub-investment credit rating further complicates Oman's access to international debt markets as it runs a pegged currency regime and closely follows the policy of US Federal Reserve. Oman thus needs to present its investors a credible story of reform and fiscal consolidation, and moreover the willingness to implement those reforms immediately, if the sovereign wants to maintain its access to the international debt markets at a reasonable cost of funding.

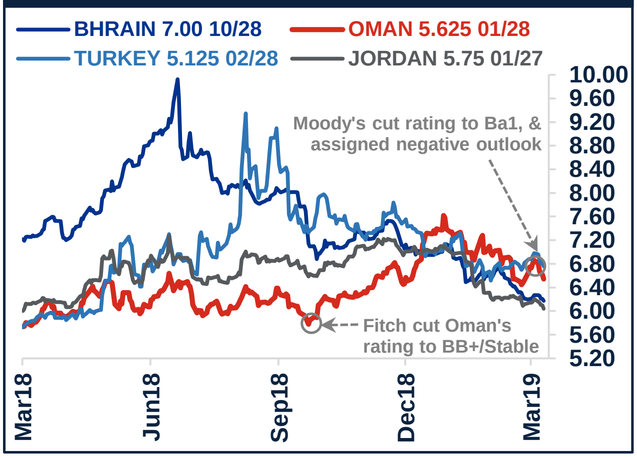
Secondary market performance

Oman's sovereign bonds were the major underperformers last year, both within the GCC and EM space, delivering a negative return of 7.30%, according to Bloomberg. With some recent encouraging comments from rating agencies, and officials from the government and the IMF, Oman's credit spreads have rallied this year but still lag their peers on relative value opportunities (as shown in the below charts).

Oman ~5Y US$ bond vs Peer bonds (YTM in %)

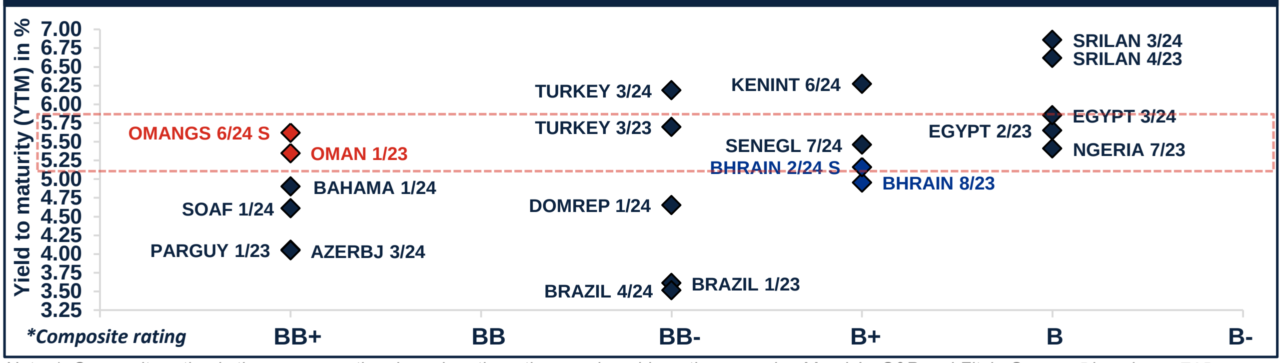


Oman ~10Y US$ bond vs Peer bonds (YTM in %)



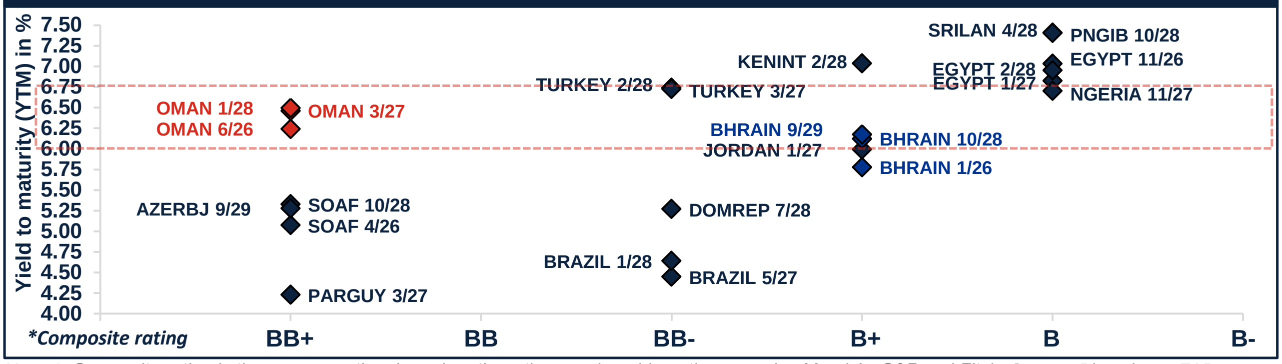
Source: Bloomberg; FAB

~5-Year sovereign bonds relative value - YTM (%) vs Composite Rating*



*Note: * Composite rating is the average rating based on the ratings assigned by rating agencies Moody's, S&P and Fitch; Source: Bloomberg; FAB*

7-to-10-Year sovereign bonds relative value - YTM (%) vs Composite Rating*



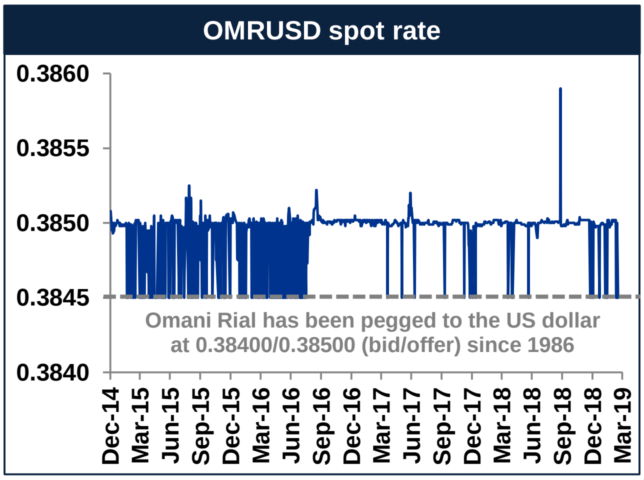
*Note: * Composite rating is the average rating based on the ratings assigned by rating agencies Moody's, S&P and Fitch; Source: Bloomberg; FAB*

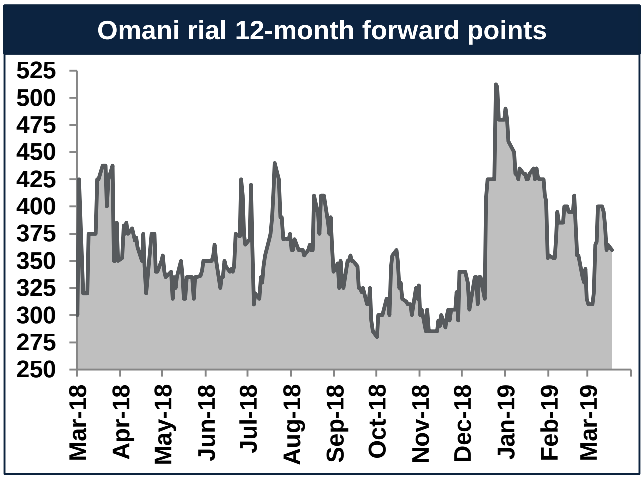
Currency matters

The Omani Rial has been pegged to the US dollar at 0.38400/0.38500 (bid/offer) since 1986. These official rates are only available to onshore banks with qualifying transactions, although the pair usually trades with a 0.39490/0.38510 spot range.

Renewed concerns that this pegged regime could come under threat is understandable especially looking the Central Bank's current low level of foreign exchange reserves ($17.4bn in Dec 2018), however a few things need to be borne in mind.

- Firstly the local currency market is relatively small and the vast majority of trades are commercial or investment related. This, together with the fact that there are only a handful of offshore interbank market makers, means that its difficult one to access for currency speculators who normally target the Saudi Riyal when looking for a regional proxy;
- Secondly the CB's reserve number does not include the assets held by the country's sovereign wealth funds which are currently estimated to be around $24bn.
- Finally a break of the peg would likely trigger a jump in speculation against the other regional FX regimes and therefore further solidifies our view outlined above, that one or two of the richer GCC states would step in to help Oman avoid such an event if required in the near to medium term.





Source: Bloomberg; FAB

Focus on diversification

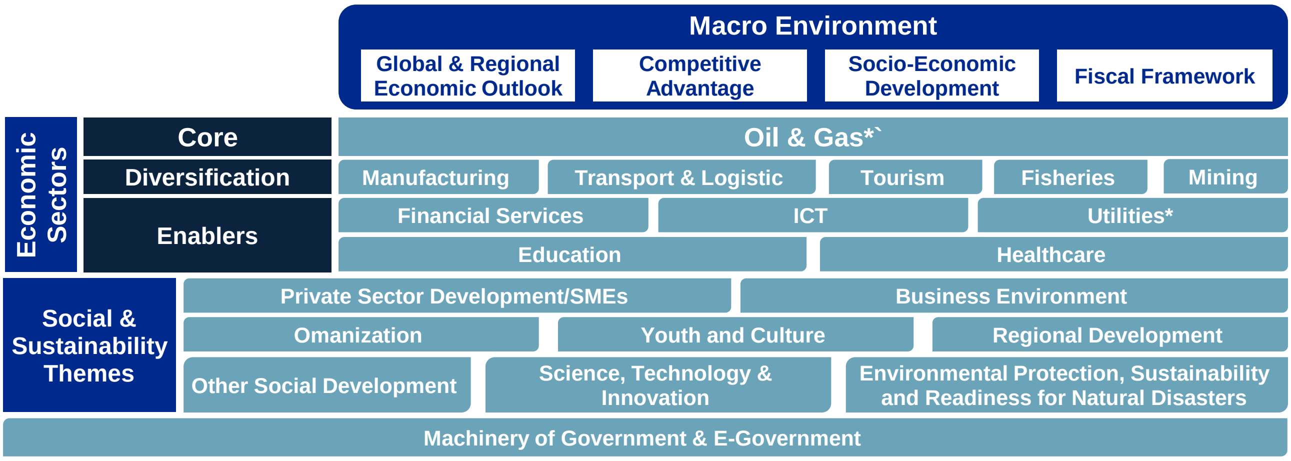
As per the Sultanate of Oman Supreme Council for Planning, economic diversification remains key to the future economic prosperity of the country and diversification away from the reliance on hydrocarbon revenue is 'a strategic direction as a precaution against fluctuations in future global oil prices'.

Economic diversification efforts across the Omani economy are based on its current Five Year Development Plan 2016-2020 (known more generally as the '9th Plan'). Moreover, the plan focuses on five promising sectors, as highlighted in the below chart, that were selected based on four major criteria to boost Oman's economic growth through 2020. Meanwhile, the Plan's formulation depended on analyzing (19) sectors in total though and their supporting economic and social impacts:

Oman's Current Five Year Plan (2016-2020)

Target sectors	Sector selection criteria
1. Manufacturing	1 Ability to provide sufficient job opportunities for Omanis
2. Transport & Logistic Services	2 High Competitiveness internationally
3. Tourism	3 Ability for sustainable and continuous growth
4. Fisheries	4 Ability to support growth in other sector of the economy
5. Mining	

*Note: * 9th Plan considers Oil & Gas and Energy as one sector; ICT is Information & communications technology; Source: Oman's 9th Five Year Plan*



*Note: * 9th Plan considers Oil & Gas and Energy as one sector; ICT is Information & communications technology; Source: Oman's 9th Five Year Plan*

Importantly, the current Five Year Plan is constructed around 'four integrated dimensions':

- Achieving a GDP growth rate that maintains the improvement in citizens' living standards.
- Achieving the shift to a diversified economy.
- Achieving financial soundness through continual support of investment and rationalizing expenditures.
- Improving the investment climate and overcoming obstacles that confront the private sector in doing business

As such, part of this diversification plan – and the expansion of the Omani tourism industry – was highlighted in January by the official opening of the new airport in the city of Duqm. The airport is part of the special economic zone in Duqm and so is designed 'to play a major role in stimulating economic and tourism activities within the zone' according to Sayyid Hamoud bin Faisal Al Busaidi, Minister of Interior.

Need for social reform

On the social side of the Oman economy, our main concern centers on weak employment conditions resulting from a lack of jobs and the adverse effects of subsidy reform on vulnerable households. The latest ILO estimate of unemployment showed a jobless rate of 17% in 2017, with youth unemployment as high as 49%. This is particularly worrying given that over 40% of the Oman population is under the age of 25.

In an effort to address such structural weakness, in January 2018 the authorities launched an initiative to provide 25,000 new jobs in the private sector and stopped issuing visas to expats for certain professions. These efforts all fall under the umbrella of Omanization, the initiative enacted by the government of Oman in 1988 aimed at replacing expatriate workers with trained Omani Personnel.

Conclusion

Oman has made some reasonable efforts to improve its fiscal position in past two years, but clearly not enough to address the two major challenges it is facing in the medium term: (1) Its rising debt burden; and (2) a looming risk of not being able refinance its debt at a reasonable cost of borrowing (which would push investor sentiment deeper into negative territory). Oman already has a strategy in place to diversify its economy, but what it lacks at present is the ability to demonstrate its willingness to expedite the overall reform agendas with a robust implementation plan. For example, it cannot afford any further delay in the implementation of Value Added Tax (VAT) and other tax reforms like special excise taxes. At the same time the sovereign needs to put a credible plan in place to control fiscal expenditure to reduce its fiscal deficit in the longer run in order to make the situation sustainable. As highlighted earlier, economic diversification and fiscal consolidation are really key to Oman's reform efforts and they have to come swiftly from the government in next two years.

Bottom line, while we remain fully cognisant of the challenges that Oman faces, and will certainly keep the sovereign on our watchlist, we do not believe Oman's financial condition is as critical as Bahrain's was last year and hence we feel that some of the bearishness towards the Oman credit story has been overdone. We remain cautiously optimistic that the Sultanate will be able to get through the current predicament.

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