

**SAUDI ARABIA: PAINFUL ECONOMIC REFORMS BUT  
PLENTY OF LIGHT AT THE END OF THE TUNNEL**

OCTOBER 2016

## HIGHLIGHTS

- **Saudi Arabia is embarking on a massive economic transformation and restructuring initiative.** Vision 2030 and the National Transformation Program (NTP) outline an extremely ambitious roadmap for a complete turnaround of the Saudi economy.
- **This plan is meant to prepare the Kingdom for a post-oil era through economic and public sector reforms, encouraging private sector and foreign investment, and gradually opening up the local economy and increasing its competitiveness.**
- Coinciding with a sharp and seemingly prolonged downturn in oil prices, **the implementation of economic reforms is causing stresses on all levels of the economy.**
- Financial pressures trickled down to all sectors of the economy. The stock market performance was the most visible sign of pain to the outside world. **The Tadawul All Share Index (TASI) lost more than 52% peak to trough between September 2014 and October 2016.**
- With oil prices stabilizing and more financial resources being successfully secured to finance a budget deficit, the most recent being the record USD 17.5 billion international bond issue, **the general sentiment seems to be turning increasingly positive.**
- The Saudi economy is definitely going through what could be one of its most critical junctions. Sticking to planned reform and carrying it forward despite the short term pain will be the biggest challenge. **Looking past the short term, however, and given the vast human and capital resources available to the kingdom, the future looks much brighter.**

**BACKGROUND**

The slide in oil prices, which started in the summer of 2014, prompted major oil producers around the world to look for alternatives for lost revenues and to balance their fiscal budgets. For the GCC countries, this is a particularly challenging task, as oil exports represent the single largest source of revenues and has been the driver of economic growth for decades.

Historically, the rhetoric about diversifying away from oil and reducing the reliance on oil revenues used to peak when oil prices turn down and then move to the sidelines when they recover. This time around, however, things seem to be radically different, at least for Saudi Arabia.

Pressured by what seems to be a supply-side driven structural change in the oil market and a sustained decline in oil prices amid a generally anemic global economic growth, Saudi Arabia announced “Saudi Vision 2030” and the shorter term National Transformation Program (NTP). Vision 2030 and the NTP outline an extremely ambitious roadmap for a complete turnaround of the Saudi economy. This plan is meant to prepare the Kingdom for a post-oil era through economic and public sector reforms, encouraging private sector and foreign investment, and gradually opening up the local economy and increasing its competitiveness.

**REFORM AND THE RESTRUCTURING OF THE ECONOMY**

The Saudi economy, an economy that has traditionally been reliant on oil export revenues and social welfare, is currently undergoing a major shift towards an economy that is less dependent on direct oil sales and more conscious of its spending habits.

Saudi Arabia’s Vision 2030, which was announced back in April, is believed to be the most comprehensive economic reform plan in the Kingdom’s history. It is a long-term vision that will act as a guide, or a blueprint, for numerous projects and reform programs at all levels of the economic landscape and the public sector.

It includes plans for wide reaching privatization projects, increasing non-oil revenues, cutting subsidies, encouraging local and foreign investments, increasing efficiency of government services, and going public with the Saudi Arabian Oil Company (Aramco) and some of its subsidiaries and operating units.

The Vision also includes multiple other initiatives aimed at reducing the country’s exposure to oil market volatility and shielding economic cycles from external shocks, in addition to tackling youth unemployment and increasing the level of “Saudization” across sectors of the economy, among many others.

Reaching the long-term ambitious goals of Vision 2030 requires shorter-term milestones to measure the overall progress and take timely corrective action whenever needed, and most importantly, it requires an enabling institutional infrastructure. The National Transformation

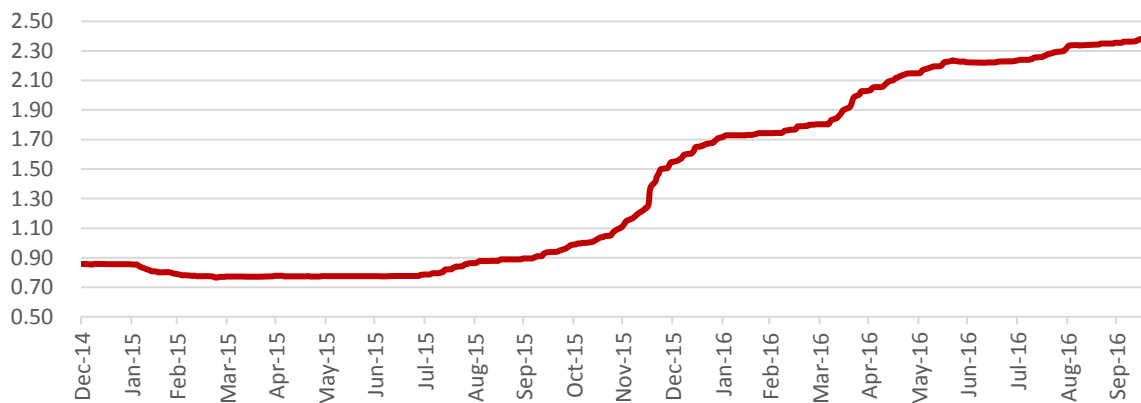
Program 2020 (NTP), a tactical roadmap for implementing the longer term strategy, was launched towards this end across 24 government entities operating in the economic and development sectors. The NTP’s strategic objectives are linked to the interim targets of the longer-term Vision 2030.

Embarking on such a huge and far reaching initiative requires tremendous resources and buy-ins from all public and private sector participants and, without a doubt, will cause some short term pain in exchange for longer term sustainable gains. Such pains have already started to manifest in the form of a liquidity squeeze in the financial sector, declines in corporate earnings and a significant underperformance the stock market.

**REPERCUSSIONS ON THE BROADER ECONOMY**

Liquidity pressures are being felt across the financial system as the government withdrew deposits from the banking sector and issued SAR bonds to local financial institutions. According to Bloomberg, local currency bond sales amounted to around SAR 98 billion in 2015 and are expected to exceed SAR 100 billion during the current year. This was reflected in a rapid increase in the 3-month Saudi interbank rate which reached 2.385% in early October compared to around 1.54% at the end of 2015.

CHART 1: SAUDI 3-MONTH INTERBANK RATE



Source: Bloomberg, NBKC

The Saudi Monetary Authority (SAMA) has been trying to employ measures targeted at relieving some of this pressure and drive rates back down. It reportedly relaxed the regulatory loan-to-deposit ratio from 85% to around 90%, offered new borrowing facilities to the tune of around SAR 15 billion earlier in the summer and has recently pledged an injection of around SAR 20 billion into the system in the form of time deposits. Even though these deposits represent an insignificant percentage of the banking system’s total assets of around SAR 2,220 billion, it is an indication that more is yet to come in terms of further easing, both from a regulatory and direct support perspectives.

Moreover, the Kingdom is tapping into new sources of funds from the international markets. It managed to successfully raise USD 17.5 billion in bonds from international markets earlier in October in three 5, 10 and 30-year tranches, priced at 135, 165 and 210 basis points above comparable treasuries respectively. This is the largest ever issue for emerging markets, taking the record from Argentina's USD 16.5 billion issue back in April.

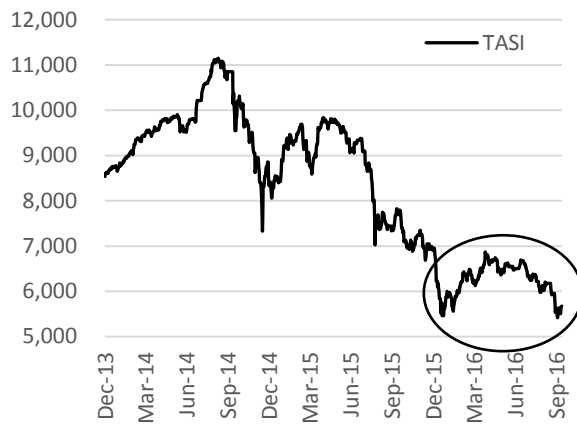
This issuance is of particular importance, not only because it is the first for Saudi Arabia, but also because it will create a benchmark off of which both the government and private sector participants in Saudi, especially banks, will be pricing their future potential international bond issues.

The financial sector was not the only sector that has been negatively affected by austerity. The stress is being felt across the whole economy albeit in different magnitudes and along different time frames. The effect on the retail sector, for instance, was mostly prominent during the current year after the reduction in fuel and utilities subsidies and cutting the benefits and bonuses of public sector employees. Retail spending has been generally muted as consumers rearranged their spending priorities and tried to balance their own household budgets.

The implementation of the development projects outlined under Vision 2030 necessitated a realignment of priorities and a revision of timelines of some ongoing projects which negatively affected contractors and cement producers and the building and construction sectors in general.

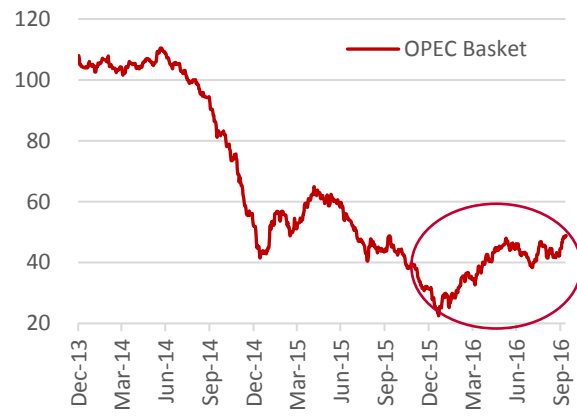
**EQUITY MARKET PERFORMANCE**

CHART 2: SAUDI STOCK MARKET PERFORMANCE



Source: Bloomberg, NBKC

CHART 3: OPEC BASKET



Source: Bloomberg, NBKC

The Saudi Stock Exchange (Tadawul) has been underperforming regional and emerging equity markets for the past two years. The downtrend started shortly after the start of the decline in global oil price in July 2014 and continued well after oil prices stabilized and partially recovered during the first half of 2016.

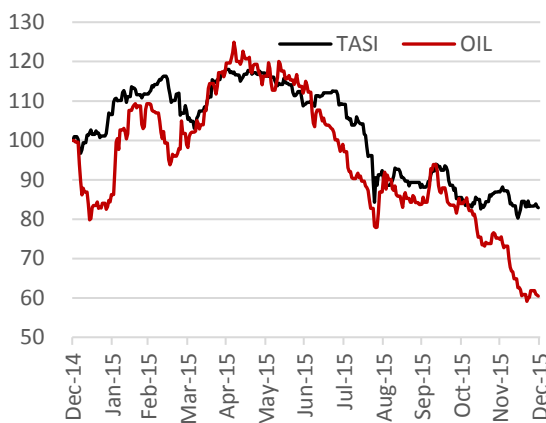
A multitude of factors have contributed to this decline and will continue to do so in the immediate term:

- Weak prospects of an oil price recovery back to the mid 2014 levels given the anemic growth of global economies and the imbalances in the oil markets.
- Regional geopolitical instability is playing a central role in shaking investors' confidence and keeping sentiments generally low.
- Austerity measures aimed at curbing public expenditures and controlling the budget deficit have probably been the most significant short term factors, pressuring stock market performance.
- More specifically, rolling back fuel and utilities subsidies at the beginning of 2016 and then cutting public sector employees' benefits later in September represented the first concrete steps that demonstrated to the general public that the government is serious in its economic reform program, pushing consumer sentiment further down. (TASI fell by more than 7% in the two days after the announcement of the public sector pay-cut which also coincided with the voting on The Justice against Sponsors of Terrorism Act (JUSTA) in the US).

Since the beginning of its decline, the index has tumbled from a high of 11,419 in September 2014 to a low of 5,416 in October of this year recording a peak to trough decline of more than 52%.

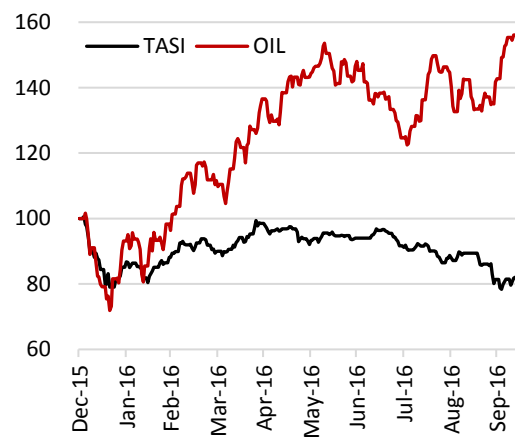
Oil on the other hand, dropped from over USD 100 per barrel to the low twenties in January 2016 then recovered strongly during the first half of the current year and seems to be holding well within the USD 45-55 range.

CHART 4: TASI RELATIVE PERFORMANCE AGAINST OIL - 2015



Source: Bloomberg, NBKC

CHART 5: TASI RELATIVE PERFORMANCE AGAINST OIL - 2016



Source: Bloomberg, NBKC

Although oil price movement explained much of the overall market performance in the last quarter of 2014 and all of 2015, it seems to have now largely decoupled from the Saudi stock market especially since February 2016. The OPEC basket is up around 56% on a year-to-date basis and more than 115% since it reached a trough of \$22.48 in January. The Tadawul All Share Index, on the other hand, has lost around 15% of its value since the beginning of the year and that's after a strong rebound in October which lifted it up from a negative 22% as of the 3<sup>rd</sup> of October.

This should not come as a surprise as the Saudi stock market is probably the most reflective of its underlying economy in terms of sector representation among its MENA peers. As the performance numbers in Table 1 show, the sectors did not react at the same time to economic developments nor in the same magnitude.

**TABLE 1: SAUDI SECTOR PERFORMANCE 2014-2016**

Sector/ % Mkt Cap	2014	2015	2016	2016 Low	2014-2016	2015-2016
Tadawul All Share Index	-2.4%	-17.1%	-14.9%	-21.6%	-31.1%	-29.4%
Banking <b>32%</b>	2.5%	-14.9%	-15.5%	-23.1%	-26.3%	-28.1%
Petrochemicals <b>20%</b>	-22.4%	-27.0%	5.7%	0.1%	-40.1%	-22.9%
Real Estate <b>10%</b>	24.2%	0.8%	-0.6%	-13.2%	24.4%	0.1%
Agriculture & Food <b>10%</b>	26.9%	-21.8%	-23.8%	-28.5%	-24.4%	-40.4%
Cement <b>6%</b>	-2.4%	-33.7%	-29.8%	-28.9%	-54.6%	-53.5%
Telecom <b>5%</b>	-26.9%	-16.5%	-22.0%	-26.1%	-52.4%	-34.9%
Retail <b>5%</b>	32.7%	-19.1%	-36.4%	-40.0%	-31.8%	-48.6%
Industrials <b>4%</b>	-7.0%	-2.5%	-12.5%	-24.5%	-20.6%	-14.7%
Insurance <b>3%</b>	5.7%	-2.5%	-12.6%	-22.5%	-9.9%	-14.8%
Energy <b>2%</b>	5.4%	1.4%	12.4%	-5.4%	20.1%	13.9%
Transport <b>2%</b>	11.8%	7.5%	-26.3%	-32.1%	-11.4%	-20.8%
Building & Construction <b>2%</b>	-5.7%	-30.4%	-31.8%	-36.1%	-55.3%	-52.6%
Hotel <b>1%</b>	22.2%	-15.0%	-56.4%	-62.0%	-54.6%	-62.9%
Multi-Investment <b>1%</b>	-15.4%	-10.3%	-33.7%	-35.6%	-49.7%	-40.5%
Media <b>0.4%</b>	-19.6%	57.3%	-56.7%	-59.4%	-45.2%	-31.8%

*Note: 2016 data until 25.10.2016, 2016 Low was on 03.10.2016, sector weights are approximates and might not add up to 100% due to rounding.*

*Source : Bloomberg, NBKC*

Of the heavyweights, the Banking sector retreated by around 28% since the beginning of 2015 and its performance was generally in-line with the broader market with marginally better performance than the general index in 2015. The Petrochemicals sector, on the other hand, which is the most correlated and most directly affected by oil prices, started to retreat in early September 2014, erasing around 21% of positive performance over the first three quarters of 2014 to close the year down 22.4% as it declined by 35.8% from September till year-end. During the current year, it has been reacting well to stability in oil prices and is the only positive performer in the market apart from the small energy sector.

Other smaller sectors that were hit the most are Retail with -49%, Cement, and Building and Construction, registering declines close to 53% each over the past two years.

## **EQUITY MARKET OUTLOOK**

The Saudi stock exchange, the largest and most liquid in the region, has long been of interest to foreign investors. The Saudi authorities, however, were always cautious about opening up the stock market to foreign investors and wanted to avoid “hot money” which increases volatility. They instead wanted to attract long term value investors which will contribute to

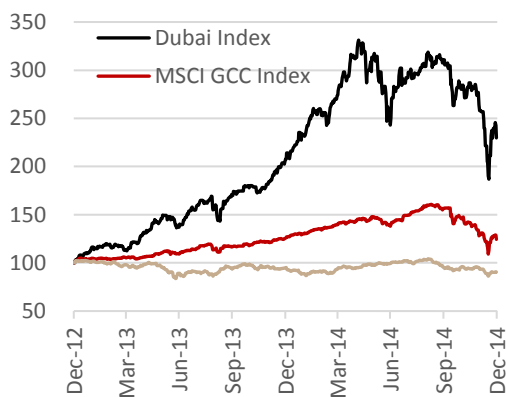


the development and maturity of the market especially in areas like research coverage, enhanced corporate governance practices, disclosures...etc.

The opening up to foreign investors was therefore gradual; first through total return swaps and specialized funds, then through the introduction of Qualified Foreign Investors (QFIs) that need to satisfy certain requirements in terms of minimum AUM levels for example, and imposing maximum limits on foreign ownership in local listed companies. These requirements were relaxed recently by lowering the required AUM levels from USD 5.0 billion to USD 1.0 billion and increasing foreign ownership limits in local companies.

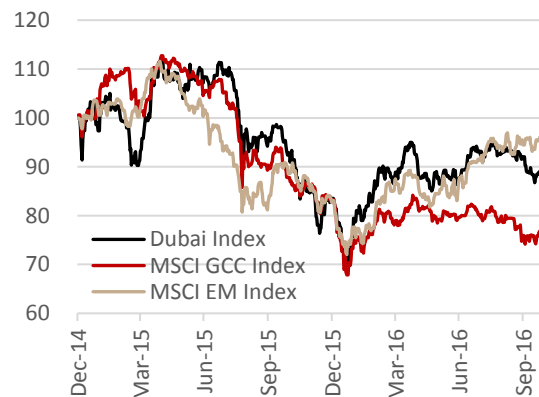
These reforms will bring the Saudi stock exchange closer to an upgrade to an emerging market status. This will have a significant impact in terms of attracting long term institutional fund flows into the market which should contribute to its stability over the long term. Should the reforms currently underway continue in the same direction, and if the Dubai Financial Market (DFM) after the inclusion of the UAE in the MSCI emerging market index is to serve as a benchmark, we would expect a significantly positive impact of such a potential inclusion on the performance of the Saudi Market, initially around the time of such an inclusion, and in the longer term due to stable passive money flows.

CHART 6: DFM PERFORMANCE RELATIVE TO EM & GCC



Source: Bloomberg, NBKC

CHART 7: DFM PERFORMANCE RELATIVE TO EM & GCC



Source: Bloomberg, NBKC

Looking past the current turmoil in the Saudi market caused initially by the drop in oil price and then worsened by the short term effects of massive economic reform, long term investors will undoubtedly see a valuable opportunity to participate in the upside of the largest and most liquid market in the region.

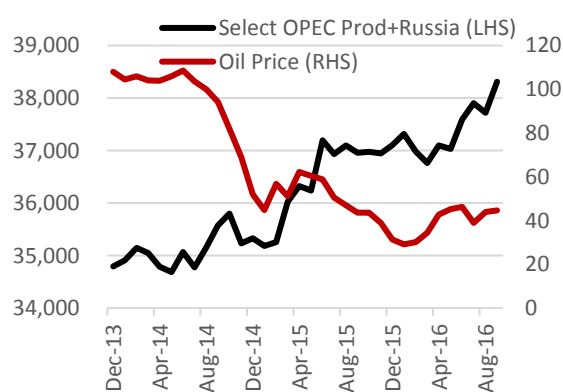
Even on the shorter term things seem to be somewhat improving as reflected in the performance of the All Share Index which bounced back by more than 8% from its low on the 3<sup>rd</sup> of October this year. The overall sentiment was boosted by several factors:

- The success of the Kingdom’s first international bond issuance which managed to raise USD 17.5 billion (SAR 65.63 billion) in fresh funds from international investors setting a new record for emerging markets.
- Comments from the Finance Minister indicating that payments to contractors have been “regularized and will rise in the coming period”. According to a Bloomberg report, 30-40% of the outstanding are to be paid before year end and the balance settled in 2017.
- IMF expecting austerity to relatively ease next year and non-oil GDP growth to increase to 2.6% from 0.3% in 2016
- A deal to cut output by OPEC members and Russia is gaining momentum and providing support for oil prices.

**THE OIL MARKET**

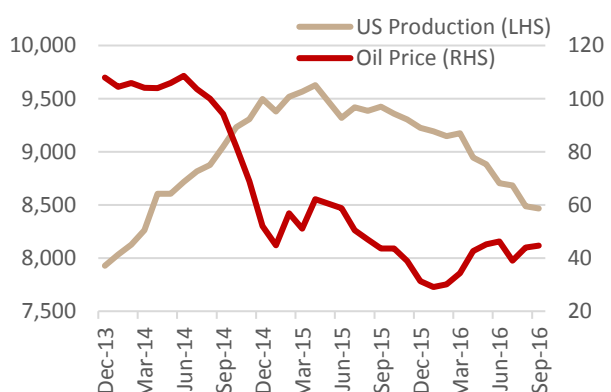
Unlike many previous oil price shocks, this time around the decline in oil prices was met with increased production from major oil producers in an attempt to capture additional market share. Saudi Arabia, in particular, spearheaded the efforts to maintain current production levels and let the markets find their balance. The main target for this strategy was the US shale oil industry which was benefiting from higher global oil prices that made more and more fields economically feasible to exploit. According to data compiled by the US Department of Energy, US oil production peaked in April 2015 and then started to decline as oil prices dipped below USD 60 per barrel (charts 8 & 9 below) while total production of major OPEC producers and Russia continued to increase.

CHART 8: OIL PRICE & SELECT OPEC PROD + RUSSIA



Source: Bloomberg, NBKC

CHART 9: OIL PRICE & US PRODUCTION



Source: Bloomberg, NBKC

The recent agreement among OPEC members to decrease production to a level between 32.5 and 33 million barrels from the current level of 33.24 million barrels, which was supported by Russia, seems to have stabilized the market for the time being.

The agreement calls for a production cut between 200,000 and 700,000 bpd. The details, however, as to which countries will be exempt from cutting and which will actually cut production and by how much was left to a committee which will try to finalize the details before the upcoming OPEC meeting in Vienna on November 30.

As a matter of fact, looking at the production figures of Saudi Arabia, Kuwait and the United Arab Emirates, it seems as if these three countries have already been freezing their production for quite some time now; Kuwait has been around 2.9 million bpd since December 2015, UAE started the current year at 2.93 million bpd, went down briefly to 2.76-2.80 then back to around 3.0 million bpd currently.

TABLE 2. MONTHLY OIL PRODUCTION FIGURES OF SELECT MAJOR PRODUCERS ('000 BPD)

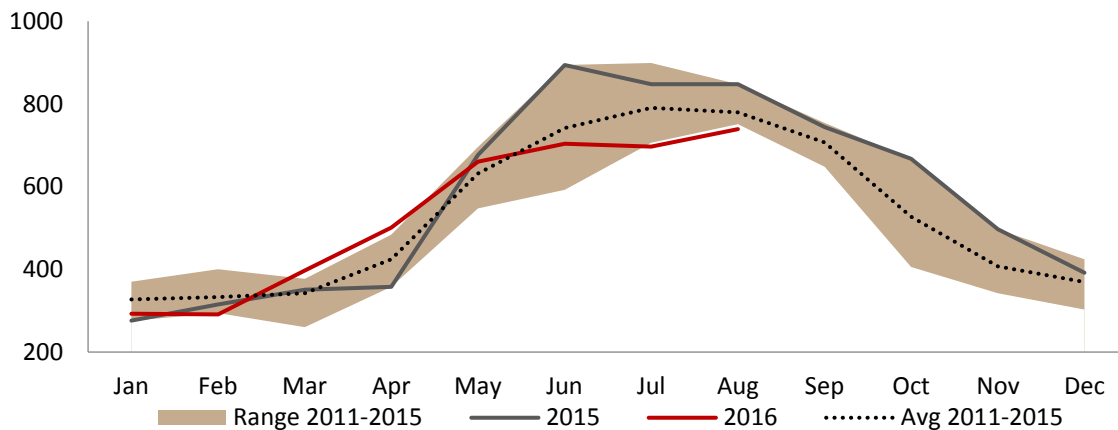
	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16
KSA	10,250	10,200	10,200	10,190	10,200	10,260	10,470	10,660	10,640	10,580
Kuwait	2,900	2,860	2,850	2,860	2,770	2,830	2,900	2,860	2,930	2,940
UAE	2,940	2,930	2,820	2,760	2,800	2,860	2,920	3,000	3,030	3,020
Qatar	680	650	650	650	670	650	660	660	660	650
Iraq	4,440	4,510	4,200	4,150	4,420	4,370	4,350	4,410	4,480	4,540
Iran	2,800	2,860	3,100	3,200	3,500	3,500	3,530	3,560	3,620	3,630
Nigeria	1,919	2,028	1,889	1,720	1,610	1,440	1,590	1,570	1,390	1,500
Libya	375	370	370	330	310	280	320	300	260	340
<b>Sub-Total</b>	<b>26,304</b>	<b>26,408</b>	<b>26,079</b>	<b>25,860</b>	<b>26,280</b>	<b>26,190</b>	<b>26,740</b>	<b>27,020</b>	<b>27,010</b>	<b>27,200</b>
Russia	10,800	10,910	10,900	10,900	10,820	10,840	10,850	10,880	10,710	11,110
USA	9,202	9,214	9,077	9,022	8,825	8,735	8,622	8,460	8,488	8,467
<b>Ex-USA</b>	<b>37,104</b>	<b>37,318</b>	<b>36,979</b>	<b>36,760</b>	<b>37,100</b>	<b>37,030</b>	<b>37,590</b>	<b>37,900</b>	<b>37,720</b>	<b>38,310</b>
<b>Total</b>	<b>46,306</b>	<b>46,532</b>	<b>46,056</b>	<b>45,782</b>	<b>45,925</b>	<b>45,765</b>	<b>46,212</b>	<b>46,360</b>	<b>46,208</b>	<b>46,777</b>

Source : Bloomberg, NBKC

Same goes for Saudi Arabia, which according to the latest data, was producing around 10.58 million bpd in September up from around 10.2 million bpd between December 2015 and May 2016. Production was ramped up slightly during the summer to accommodate local consumption needs.

Saudi Arabia's domestic consumption increases significantly in the summer to satisfy the increase in the demand for energy for cooling. This summer, domestic consumption reached a peak of 739K barrels in August and is expected to drop back to its historical average of around 300K barrels by year-end. Taking this factor into consideration, Saudi production of crude has been relatively stable.

CHART 10: SAUDI ARABIA'S DIRECT USE OF CRUDE OIL



Source: JODI (Joint Organizations Data Initiative)

The production level of Iraq has been relatively stable at around 4.5 million bpd. That of Nigeria and Libya, on the other hand, has been lower than average lately, driven by violence and political instability but is expected to add some 800k barrels to world supply shortly. Despite this, and due to political instability and security issues in the three countries, production level volatility is expected to persist. Any resulting shortfall production would be easily covered by the spare capacity of other OPEC producers, especially from Saudi Arabia.

The real issue that stood in the way of an output freeze agreement on the previous attempts was the insistence of Iran to be exempted from such a freeze until it reaches its pre-sanctions levels of production of a little under 4 million bpd which is something that has been practically achieved. Iran's oil production has been steadily rising ever since international sanctions have been lifted. Total production increased from 2.8 million bpd in December 2015 to around 3.6 million bpd in the summer of 2016 and has been stable around that level. Any further production capacity increases from current levels would need significant investments and time to materialize.

### OIL PRICE OUTLOOK

Market consensus seems to be that oil price will be moving within a band of around USD 45-60 per barrel in the short term with a slight bias towards the upper limit, which seems to be the base case scenario that most oil producing countries are basing their assumptions on, and for a good reason.

Oil prices below USD 45/bbl proved to be too painful for oil producers who are struggling to balance their budgets and support economic growth or at the very least contain the effects of an economic downturn. For Saudi Arabia in particular, the rapid decline in oil prices added to the financial stresses on the economy caused by going through a major economic reform program.

What the oil market is going through today is a competition on market share between traditional oil producers led by OPEC, and non-traditional producers led by the US shale oil industry. This struggle, which has been in play for the past two years, has resulted in what seems to be a relatively hard ceiling of around USD 60/ bbl above which US shale becomes feasible resulting in an increase in supply. It follows that it has become very challenging for OPEC to manage a price increase beyond the current levels, while traditional producers cannot endure a price lower than USD 40-45 for extended periods of time. The more pressing challenge for OPEC currently, and the more realistically achievable goal, is to prevent prices from falling further rather than trying pursue a price recovery beyond USD 60 which seems to be out of their control.

### **FINAL THOUGHTS**

The initial combined effects of oil price declines and stresses caused by economic reform seem to be moving past their peak. At least on a psychological level, what was thought of previously as unthinkable such pay cuts and subsidy reductions is now a reality. Going forward, any additional such measures would have a lesser effect on the general public.

It looks like the initial shock of austerity which resulted in wide disruptions across the Saudi economy has been absorbed and a second wave of measures is likely to be less severe.

Economists are expecting a lower budget deficit for the current year and next, and a better outlook for oil and non-oil GDP growth. Stable oil prices, even at current levels, will contribute to financial stability

The success of the first ever issue of international bonds by the Saudi government, which has set a new record in terms of size for emerging markets, has provided a substantial sentiment boost across all levels of the economy.

The Stock market seems to have fully discounted the effect of a lower oil price and has rebounded well off its lows especially after the bond issue.

The first phase of reform had to start with cost cutting and rationalizing expenditures. Subsequent steps, while most likely will carry more austerity, will also secure more revenue sources for the government which will be associated with spending that is more in line with the Vision 2030 and contribute to economic growth.

Any traction on the listing of Aramco and/or its subsidiaries will provide significant resources for the government and more importantly will provide a significant boost to the local stock market.

Contacts:

**Investment Advisory  
Asset Management**

Arraya Tower II, Floor 35  
P.O. Box 4950, Safat 13050, Kuwait

T. (965) 2224 5111

F. (965) 2224 6904

E. [NBKCAPITAL.IA@nbkcapital.com](mailto:NBKCAPITAL.IA@nbkcapital.com)

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