KAMCO INVEST

Investment Strategy & Research

Event Update - S&P Downgrades Kuwait & Oman

March-2020

Downgrade outlines fiscal concerns from lower oil prices…

In a significant move, S&P downgraded the credit ratings of two GCC sovereigns, Kuwait and Oman, by one notch on oil price weakness citing pressure on the fiscal front for the two oil exporting countries. The ratings action reflects S&P's lowered assumption for oil prices in which it expects average Brent oil price of USD 30/b in 2020, followed by USD 50/b in 2021 and USD 55/b for 2022. *The downward revision for oil prices came after OPEC+ failed to reach an agreement to extend the production cut agreement beyond the current deadline of March-2020. Post this development, the impact of the spread of Covid-19 on global oil demand, drove Brent crude spot prices to plunge almost 70% from the year's peak to an 18-year low level of USD 22.8/b.*

The agency lowered Kuwait's long-term foreign and local-currency credit ratings by a single notch to 'AA-' from 'AA' and maintained a Stable outlook on the rating. ***The downgrade highlights significantly low oil prices for this year and for 2021 that S&P expects would hamper the fiscal position of the country due to the over reliance on oil revenues.*** *S&P also highlighted Kuwait's lagged reform as compared to other countries in the region over the last few years. Nevertheless, they mentioned that the stable outlook reflects the country's sizable fiscal and balance-of-payments buffers that provide it with headroom for policy measures over the next two years. The downgrade also included their expectations of a decline in demand from some of the biggest Asian buyers of oil due to the Covid-19 impact.*

Oman's sovereign rating was downgraded deeper in to the non-investment grade category from BB+ to BB with a negative outlook. *The downgrade once again reflects S&P's view of fiscal and external pressure from lower oil prices resulting in a faster deterioration of the Sultanate's balance sheet. The negative outlook was ascribed to the risk that the government's fiscal consolidation plan would be insufficient to contain the rise in government debt levels.*

We believe that the oil price outlook by S&P shows an extremely depressed view of the oil market for the reminder of 2020. The average oil price expectation of USD 30/b is too low, in our view, as the current median forecast for Brent according to consensus estimate is at USD 44/b for 2020, increasing to USD 55/b in 2021. *Moreover, we believe that the current oil market is oversold and reflects panic in reaction to the Covid-19 situation, coupled with the excess supply coming out of the failed OPEC+ meeting, ignoring any likely production cuts in the near term. It fails to take into account the expected decline in supply from the shale producers as a majority of the companies in the shale patch have announced severe cut in spending for the near term. A number of datapoints suggest a decline in production activity in the US, despite assurance from a government support for the sector.*

We also believe that the revival of pent up oil demand during 2H-2020 should provide some support to oil prices. *As a result, we believe that the ratings actions comes too early and overlooks the expected pickup for the oil market during the 2H-2020 that includes higher demand led by lower prices. In addition, the expected increase in output of Kuwait post the withdrawal of the limits should offset some of the concerns related to lower oil revenue. According to Bloomberg data, Kuwait has a spare production capacity of around 0.4 mb/d that can push its current oil production from 2.7 mb/d to 3.1 mb/d when fully utilized. This excludes the share of Kuwait coming from the 0.5 mb/d total capacity of the Neutral Zone shared with Saudi Arabia. In terms of government revenues, we continue to maintain that policy tools such as the of imposition of selective taxes and the introduction of VAT remain available for Kuwait, and should be implemented as and when required.*

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GCC Sovereign Ratings

	S&P		Moody's		Fitch	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Bahrain	B+	STABLE	B2	STABLE	BB-	STABLE
Kuwait	AA-	STABLE	Aa2	STABLE	AA	STABLE
Oman	BB-	NEG	Ba2	STABLE	BB	NEG
Qatar	AA-	STABLE	Aa3	STABLE	AA-	STABLE
Saudi Arabia	A-	STABLE	A1	STABLE	A	STABLE
UAE	N/R	N/R	Aa2	STABLE	N/R	N/R
Abu Dhabi	AA	STABLE	Aa2	STABLE	AA	STABLE

Source : Bloomberg

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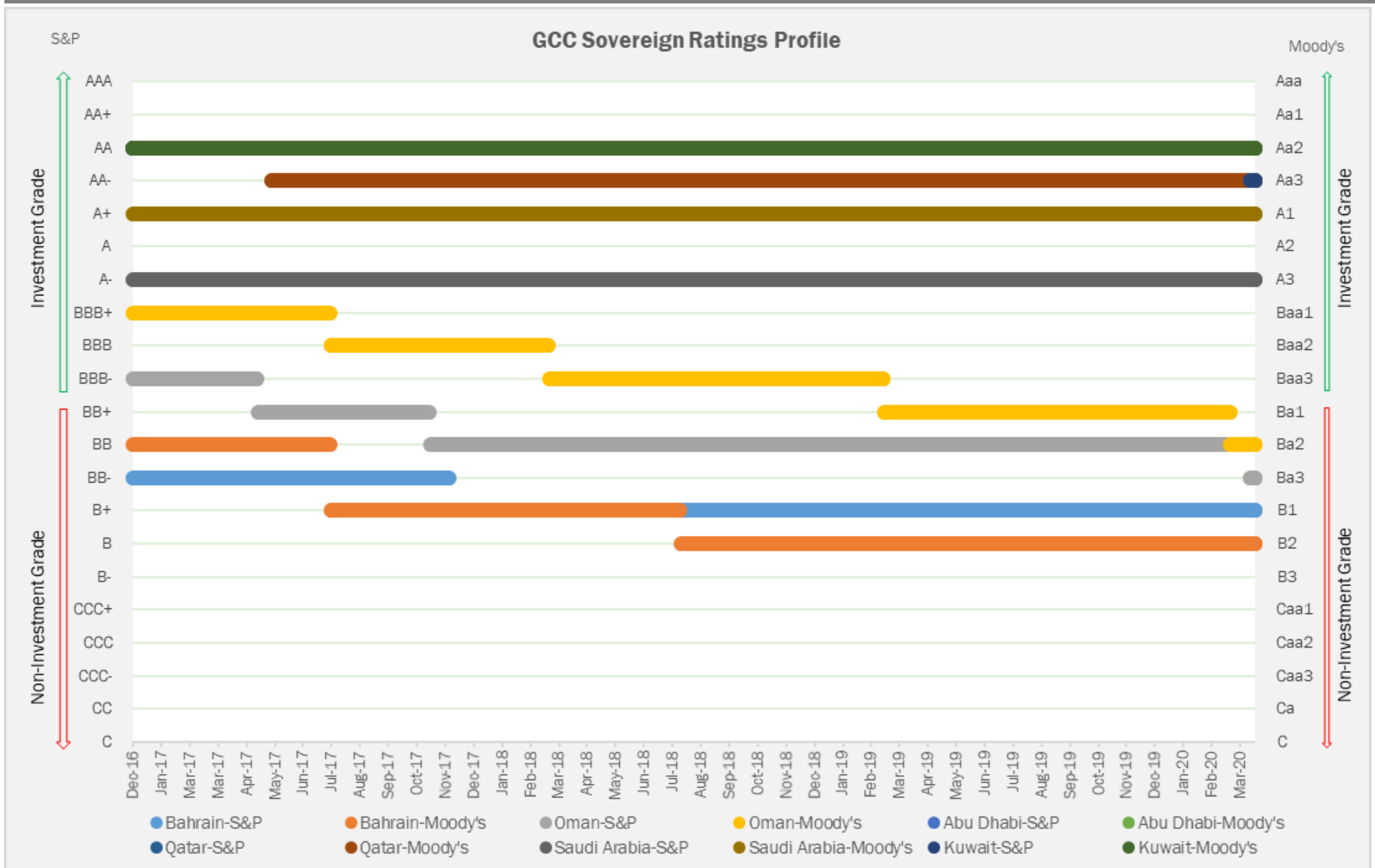
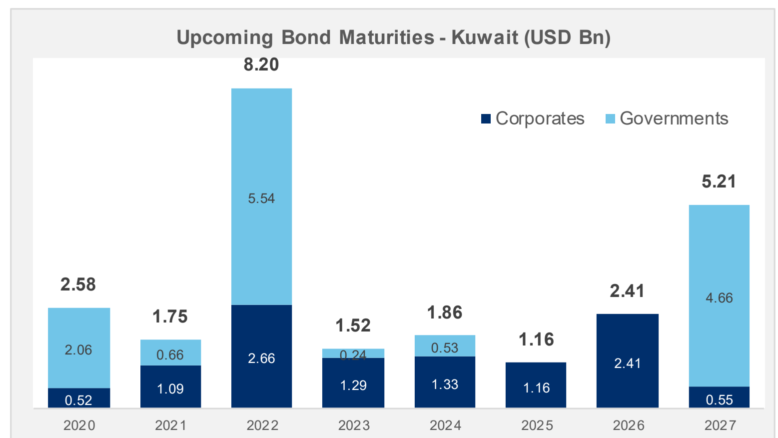


Source : Bloomberg, Kamco Invest Research

Implications of the downgrade for Kuwait

We believe that there is a need for context to be set to understand the implications of this downgrade. This was the first ratings downgrade from S&P for Kuwait since 2011, as Kuwait's ratings remained stable even during the oil crisis of 2016. The lower ratings in our view therefore brings Kuwait on parity with some of the other key GCC hydrocarbon exporters. We derive a budget deficit estimate sensitivity of KWD 215 Mn for Kuwait's 2020/21 budget on a USD 1/b change in oil prices at a production rate of 2.8 mb/d (See page 3 for details). Nevertheless, we believe that Kuwait's fiscal strength for funding deficits and driving non-oil growth capex remains comfortable with Government Assets currently 4.6x higher than 2020 nominal GDP estimates. Moreover, we feel budget deficits can be plugged in by debt issuances if the revised debt law authorizes the government to take the international debt market route.

Moreover, although the ratings downgrade translates into higher borrowing costs, we feel the current low interest environment and Kuwait's lower debt issuance vis-à-vis GCC peers would create significant demand for the country's issuances. The ratings downgrade could also translate into lower ratings and higher borrowing costs for corporates whose revenues are significantly linked with Kuwait's oil revenues.



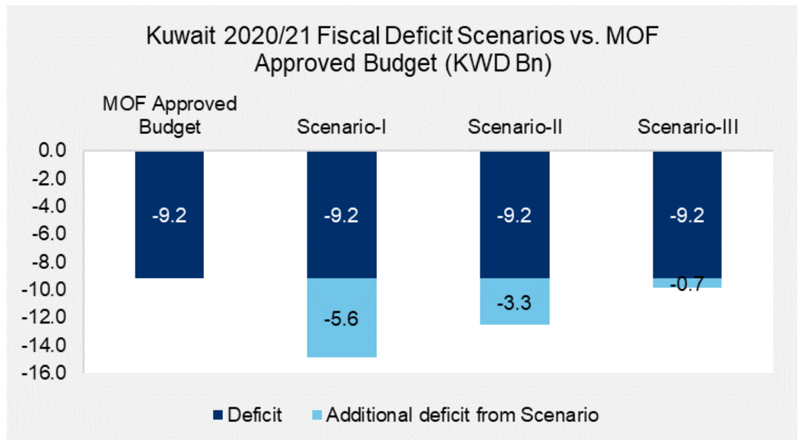
Source : Bloomberg, Kamco Invest Research

Near term debt rollover risks remain minimal as almost 85% of all outstanding corporate debt have a maturity beyond 2021, but we believe companies with higher net cash accruals to total debt (NCATD) and cash debt-service coverage (CDSCR) ratios would benefit from the lower interest rate environment. In terms of Kuwait's currency basket peg, we remain comfortable as KWD 12M forwards remain well below 2008 GFC levels and 2016 oil crisis levels, pointing towards stability for KWD going forward.

Stress testing budget finances on oil scenarios

The Ministry of Finance approved a budget with total revenues of KWD 14.8 Bn and expenses of KWD 22.5 Bn. Budget deficit came to KWD 9.2 Bn after Future Generation Fund (FGF) withdrawals based on an oil production levels of 2.7 mb/d and an average oil price of USD 55/b.

We stress tested Kuwait's 2020/21 fiscal deficits on various oil price levels and oil production scenarios:



Source : Kuwait MOF, Kamco Invest Research

- **Scenario I (Oil price of USD 25/b and oil production raised to 3.0 mb/d :** If OPEC+ produces unbated, we expect Kuwait's oil production to go up to 3.0 mb/d. If prices in this scenario were to come down to USD 25/b, we expect 2020/21 budget deficits to widen to KWD 14.8 Bn.
- **Scenario II (Oil price of USD 35/b and oil production raised to 3.0 mb/d:** If average prices stay at USD 35/b, we expect 2020/21 budget deficits to widen to KWD 12.5 Bn.
- **Scenario III (Oil price of USD 50/b and oil production at 2.8 mb/d:** This scenario models OPEC+ reaching a consensus and lower cuts being implemented. We forecast 2020/21 budget deficits to widen marginally to KWD 9.8 Bn in this scenario.

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