SAUDI ARABIA ECONOMIC REPORT

FUNDAMENTAL STRENGTHS OUTPACING KEY CHALLENGES FOR THE KINGDOM'S ECONOMY

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CONTACTS

Research

Marwan S. Barakat
(961-1) 977409
marwan.barakat@banqueaudi.com

Jamil H. Naayem
(961-1) 977406
jamil.naayem@banqueaudi.com

Salma Saad Baba
(961-1) 977346
salma.baba@banqueaudi.com

Fadi A. Kanso
(961-1) 977470
fadi.kanso@banqueaudi.com

Sarah F. Borgi
(961-1) 964763
sarah.borgi@banqueaudi.com

Gerard H. Arabian
(961-1) 964047
gerard.arabian@banqueaudi.com

- Favorable macro performance though at a slower rate of growth

Economic performance in the Kingdom has been strong over the past year, with growth supporting further increases in per capita income. Newly released real GDP data from the Central Department of Statistics and Information have revealed that the annual rate of growth thus surpassed expectations, reaching 3.8% last year, though lower than the 5.9% recorded in 2012. The private sector, for its part, grew by 5.5% last year on the back of strong government spending that lead to a rise in business and consumer confidence as well as bank lending. Among the strongest performing sectors were construction (8.1%), transport and communication (7.2%) and wholesale, retail, restaurants and hotels.

- Slightly contracting oil sector output over the past year

During the year 2013, the Kingdom pumped lower levels of oil, and witnessed a marginal contraction in the oil sector. Oil consumption in the Kingdom contracted from previous years. In details, KSA's oil output averaged 9.64 million barrels per day during 2013, down by 1.3% from 2012. Within the context of a slowdown in production and a stagnation in prices (+1.9% in 2013), the oil sector posted a real contraction of 4.1% in 2013, against an expansion of 7.9% in 2012. Still, KSA's oil sector continued to form the basis of the economy and accounting for circa 47.4% of GDP.

- Lowest fiscal surplus in three years on lower oil revenues and higher capital expenditures

Saudi Arabia's fiscal performance in 2013 was underpinned by a decline in revenues for the first time since 2009 due to lower oil revenues, while expenditures gathered pace driven by high capital spending on large projects. Within this context, the Kingdom's fiscal surplus witnessed in 2013 its first contraction in three years. It fell by 51.8% to reach US$ 48.1 billion in 2013, accounting for 6.4% of GDP, as per SAMA In parallel, the country's gross public debt pursued its downward trajectory to reach its lowest level ever of 2.7% of GDP at end-2013, as per SAMA.

- Stability in policy rates amidst a contained level of inflation

Monetary conditions in Saudi Arabia were characterized by a relatively eased inflation during the first quarter of 2014, a firm stability in key policy rates, an extended growth in SAMA's reserve assets to reach a new record high level at end-March 2014, and a moderate rise in monetary aggregates. In details, Saudi inflation remained relatively contained during the first quarter of 2014, with the cost of living index increasing by 2.8% on average over the said period after rising by 3.5% on average in 2013. SAMA's reserve assets actually grew by 1.1% during the first quarter of 2014 after surging by 10.5% in 2013, to reach a new record high level of US$ 733.7 billion at end-March 2014.

- Continuously solid banking activity growth and financial soundness indicators

Saudi banks continue to benefit from a favourable operating environment. Total assets of banks operating in the Kingdom rose by 9.2% last year and by a further 5.1% in the first three months of 2014. The Kingdom's banks benefit from an adequate liquidity stance, with primary liquidity of 19% of their total deposits at end-March 2014. Profitability ratios remain comfortable, with the annualized return on average assets ratio at 2.1% and the annualized return on equity ratio at 15.8% in the first quarter of 2014. The sector remains well capitalized despite strong asset growth, with regulatory capital to risk-weighted assets ratio of 17.9% at end-December 2013. In parallel, banks continue to enjoy strong asset quality metrics, with non-performing loans to total gross loans ratio reaching a post-global crisis low of 1.3% at end-December 2013, depicting a steady yearly decline over the past few years.

- Sustained economic activity growth despite austere budget in the year ahead

In 2014, it is expected that the improved performance evident in the second half of last year will be maintained, as the impact of the massive outflow of expatriates in 2013 dissipates and oil production remains somehow robust. This should be sufficient to push real GDP growth slightly higher to 4.1% this year. It is worth noting that after several years of expansionary state spending, the government passed a considerably more austere budget for this year, with total spending budgeted to rise by just 4.3% in 2014, compared with increases of 17% in 2013 and 19% in 2012. With that in mind, 2014 should provide a revealing insight into the country's future growth potential, as the economy begins its process of rebalancing away from the government.

The Saudi Arabia Economic Report can be accessed via internet at the following web address: http://www.banqueaudi.com

Bank Audi sal - Group Research Department - Bank Audi Plaza - Bab Idriss - PO Box 11-2560 - Lebanon - Tel: 961 1 994 000 - email: research@banqueaudi.com

Economic performance in the Kingdom has been strong over the past year, with growth supporting further increases in per capita GDP and income. Newly released real GDP data from the Central Department of Statistics and Information have revealed that the annual rate of growth thus surpassed expectations, reaching 3.8% last year, though lower than the 5.9% recorded in 2012. The private sector, for its part, grew by 5.5% last year on the back of strong government spending that lead to a rise in business and consumer confidence as well as bank lending. Among the strongest performing sectors were construction (8.1%), transport and communication (7.2%) and wholesale, retail, restaurants and hotels.

It is worth mentioning that an acceleration of growth in the second half-year largely came on the back of an upturn in the oil sector, raising questions about the potential of the non-oil sector to become the motor of the Kingdom's economy. Another major contributor to the pick up in growth was petrochemicals, as demand from East Asia for Saudi intermediate goods (petrochemicals and refined products) has been boosted in the past six months or so as their own exports to the US and the Eurozone have gathered steam.

As a matter of fact, real GDP growth strengthened significantly in the second half of the year, growing by a quarterly average of 4.4%, compared with 3.1% in the first half. This was a reflection of a marked turnaround in the oil sector, which had contracted in the first half of the year on the back of lower oil production. With Saudi Arabia stepping in for disrupted Libyan oil exports in the second half of 2013, oil output surged from an average of 9.4 million barrels/day in the first six months of 2013 to over 9.9 million barrel/day. As a result, having contracted by almost 5% in the first half of last year, the oil sector component of real GDP expanded by 4.6% year on year in the final quarter.

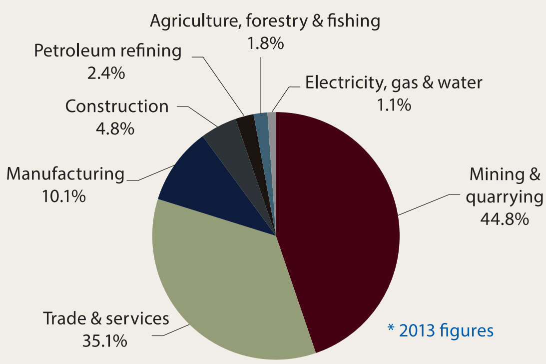
Relatively aggressive labor market reforms have caused a jump in the employment of nationals in the private sector and are helping to offset a potential source of social stress. The government formalized the status of all expatriate workers in 2013, with around 1 million, many of whom were in the country illegally, left while around a further 200,000 illegal migrants were deported after an amnesty lapsed. Some sectors have experienced short term disruption due to a correction of the status of expatriate workers, although this has largely dissipated. The formalization of expatriate labor appears to have only had a marginal impact on growth, probably indicating that the activity of many illegal works was not captured in the formal sector and the loss of productivity from others was not high. Reforms to improve the flexibility and productivity of the national labor force are ongoing while unemployment remains relatively high.

Saudi Arabia is increasingly enjoying a substantial net creditor position and a strengthened external balance sheet. The net creditor position rose to 59% of GDP at end-2013, owing to a general government surplus of 7.1% of GDP. Sovereign net foreign assets rose to 113.5% of GDP and the net external creditor position exceeded 100% of GDP for the first time at end-2013. There is no sovereign external debt in the Kingdom. There were double-digit current account surpluses in 10 of the past 11 years, with the

NOMINAL GDP AND REAL GROWTH RATES

Sources: IMF, Bank Audi's Group Research Department

GDP BREAKDOWN BY ECONOMIC ACTIVITY*



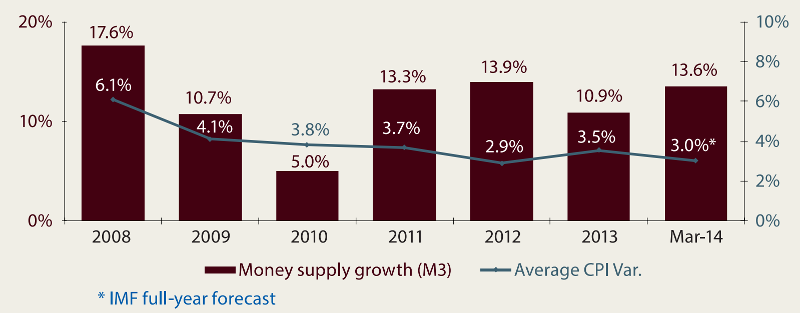
Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

surplus reporting 17.6% of GDP in 2013. The strong current account surplus in 2013 comes despite a rise in remittances by 20%, to 4.6% of GDP, as expatriates' uncertainty about their status encouraged greater outflows.

It is yet worth mentioning that the general government surplus halved as a percentage of GDP in 2013 relative to 2012 within the context of lower revenues and higher spending. The fall in revenues stemmed from lower oil prices and production. Non-oil revenues were at an all-time high, partly due to labor registration fees, but only accounted for 10% of total revenues. Central government spending rose by 12%, with the increase concentrated in capital spending and supplies and services payments. The 19% rise in capital spending is tied to the fact that the government pushed contractors to finish projects that had been delayed. The 46% growth for supplies and services was mainly due to emergency expenditure that is believed to be non-recurring. The government wage bill declined for the first time since 2001, reflecting slower hiring and the outsourcing of some services, such as health care, to the private sector at large.

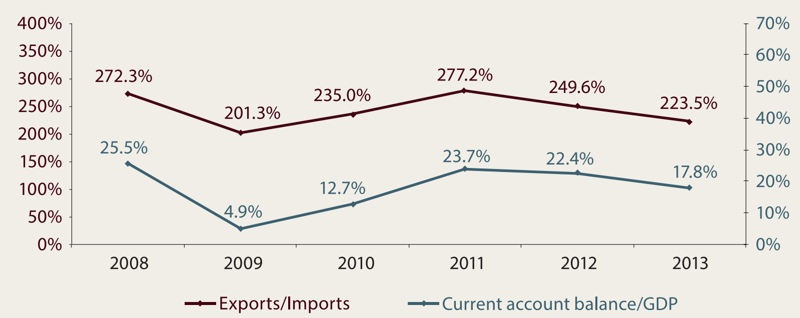
The detailed developments in the real sector, external sector, public sector and financial sector are outlined in the sections that follow while the concluding remarks address the Kingdom's near-term economic outlook looking forward.

MONEY SUPPLY AND INFLATION



Sources: Saudi Arabian Monetary Agency, IMF, Bank Audi's Group Research Department

FOREIGN SECTOR INDICATORS



Sources: Saudi Arabian Monetary Agency, IMF, Bank Audi's Group Research Department

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Hydrocarbon Sector

Lower levels of oil production alongside a contraction in the oil sector in the Kingdom

During the year 2013, the Kingdom pumped lower levels of oil, and witnessed a marginal contraction in the oil sector. Oil consumption in the Kingdom contracted from previous years. Moreover, with global energy demand rising and concerns about reliability of supply persisting, Saudi authorities, through Saudi Aramco, revived plans to develop a number of heavy-oil fields.

In details, KSA's oil output averaged 9.64 million barrels per day during 2013, down by 1.3% from 2012. The growth rate of average oil output per day was lower than that in 2012, which reached 4.9%, as per the Saudi Arabian Monetary Agency (SAMA). The Kingdom's yearly crude oil production, was down by 1.56% in 2013 from the level of production in 2012. It is worth noting that, while KSA withholds nearly one fifth of the world's largest proven oil reserves totaling 265.8 billion barrels at end-2013, its reserves-to-production level was at circa 76 years, marginally rising from a total of 75 years seen in 2012, as per SAMA.

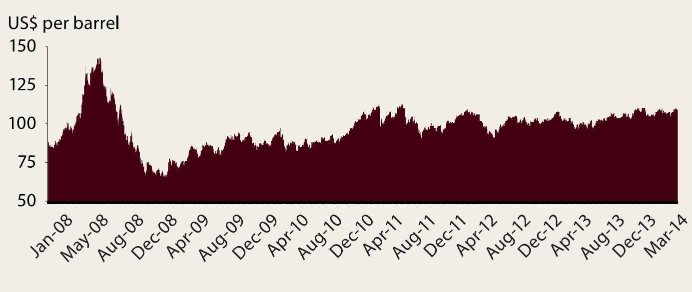
Within the context of a slowdown in production and a stagnation in prices (+1.9% in 2013), KSA's oil sector still formed the basis of the economy and accounting for circa 47.4% of GDP. The oil sector posted a real contraction of 4.1% in 2013, against an expansion of 7.9% in 2012.

Such a slowdown was felt on the external front as much as the internal one. The growth of oil exports, which make up 78% of total exports, declined by 3.7% in 2013 from the previous year. In contrast, oil exports in the Kingdom witnessed expansions of 7.1% in 2012 and 50.5% in 2011, according to SAMA. Consequently, public revenues related to the oil sector slowed down by 9.6% in 2013 from the previous year, against an expansion of 10.7% in 2012. Despite the decline in oil revenues in 2013, it is important to note that the oil sector still accounts for 90% of total government revenues.

Moving on to oil consumption in the Kingdom, it witnessed a decline from the 9% expansion achieved in 2012 to reach a lower 1.8% expansion in 2013, according to the Economist Intelligence Unit's energy report. The most significant increases in oil consumption in 2013 were seen at the level of the following segments: transport (+7.6%), electricity (2.8%), industry (+2.1%). On the other hand, residential consumption was down by 37.7%, as per the EIU.

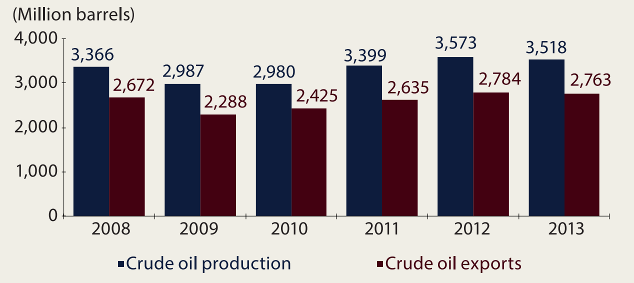
In order to offset declining output at some oil fields, Saudi Aramco is in the process of bringing new fields on stream and expanding recently developed fields, as per the EIU. The most high-profile recent example is the offshore Manifa oilfield, which came on stream in April 2013. Its output would rise from the current level of 500,000 barrels per day to full capacity of 900,000 barrels per day by end-2014. In addition, Saudi Aramco plans to add another 250,000 barrels per day of new production capacity at the

CRUDE OIL PRICES



Sources: Bloomberg, Bank Audi's Group Research Department

OIL PRODUCTION AND EXPORTS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

Shaybah oilfield. The company also signed an agreement in February 2014 for the next phase of the Wafra oilfield development in the Neutral Zone (shared with Kuwait), which would lift output at the field by 80,000 barrels to day.

With regards to the gas segment, KSA's reserves are estimated at 293,685 billion cubic feet in 2013, up by 1.0% from 2012, as per SAMA. Gas production accelerated in 2013, rising by 12.4% following an increase of 11.5% in 2012, as per the EIU. Gas production is expected to rise sharply during the forecast period, increasing from an estimated 77.7 million tons oil equivalent (toe) in 2012 to 167 million tons in 2020, as Saudi Aramco invests heavily in the sector, as per the Economist Intelligence Unit KSA Energy report. Saudi Aramco plans to raise raw gas output to 15.5 billion cubic feet per day by 2018. The company is developing several gas projects, including its first offshore field, Karan, which came on stream in July 2011. Saudi Aramco is also developing the Wasit offshore non-associated gas field, which is expected to produce up to 2.5 billion cubic feet per day by mid-2014, as per the EIU.

Despite the Kingdom's marginal decline in oil production in 2013, the oil sector remains of core importance to the Saudi economy. Moreover, higher oil prices witnessed in 2014 would steadily narrow the country's fiscal surplus and increase liquidity. It is important to note that Saudi Arabia is gradually diversifying its economy away from the oil sector, and the latter could be a driver for the marginal slowdown in the sector. The Kingdom also plans to be a net exporter of solar power within the next 30-50 years, and plans to open 16 nuclear power plants by 2032.

1.1.2. Non-hydrocarbon Sector

Another year of healthy correction

The non-oil sector in Saudi Arabia continued to outpace its oil counterpart, growing at a level of 5.4% in 2013. This, however, remains below the levels of 5.8% and 8.0% reported in 2012 and 2011, respectively, reflecting the impact of a diminishing expansionary stance and, to some extent, the knock-on impact of the Saudiisation program on the government infrastructure plans.

Accordingly, while the non-oil private sector maintained its 2012 level of growth at 6.0%, the public component of the sector reported a growth of just 3.7% in 2013, compared to 5.5% in 2012.

Figures from the Saudi Arabian Monetary Agency (SAMA) show that the construction sector reported

REAL SECTOR INDICATORS

	2008	2009	2010	2011	2012	2013	Var 13/12
Industrial production							
Number of operating industrial units	4,469	4,661	4,858	5,001	5,862	-	-
Number of workers in operating industrial units	466,661	512,630	544,484	595,134	766,908	-	-
Power generation capacity (in MW)	34,958	38,681	40,697	43,070	44,371	45,908	3.5%
Peak load (in MW)	35,240	40,858	45,661	48,461	51,939	53,864	3.7%
Number of subscribers (in 000s)	5,421	5,702	5,998	6,341	6,731	7,143	6.1%
Power sold (in millions of KWh)	181,097	193,472	212,263	219,662	240,288	256,688	6.8%
Construction activity							
Cement production (in 000s of tons)	29,656	31,976	34,309	38,290	42,187	42,829	1.5%
Domestic cement sales (in 000s of tons)	28,136	31,145	33,072	37,440	41,970	42,523	1.3%
Trade and services							
Foreign trade (US$ million)	428,596	287,840	358,006	496,285	543,994	544,113	0.0%
Number of passengers at the airports (all airlines, in millions)	42	42	45	52	65	68	4.5%
Number of flights	365,686	420,873	439,510	468,648	558,791	565,631	1.2%
Cargo handled at the airports (in 000s of tons)	565	531	571	642	1,018	1,059	4.0%

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

the highest real growth among non-hydrocarbon industries at 8.8% in 2013, compared to a much lower growth of 4.8% in 2012. Second comes the transport, storage, and communication sector which grew by 7.1% in 2013, compared to a level of 6.0% in 2012. For instance, Saudi Arabia's budget for 2013 has allocated a sum of US$17.3 billion for the infrastructure and transportation sector, of which US$ 8 billion has been used in development of 3,700 km of roads, up gradation of existing and construction of new ports and airports.

The sector of wholesale and retail trade, restaurants and hotels grew by 6.6% in 2013, compared to 6.4% in 2012. This relatively healthy rate of growth, including the one reported for the fourth quarter of 2013, eases worries regarding the impact on the overall economy that may be caused by the huge crackdown on expatriates with invalid visas. The manufacturing sector, besides petroleum related industries, which is also largely dependant on foreign labor, managed to report a healthy performance, growing by 5.3% in 2013, higher than the rate of 4.9% registered in 2012. However, according to the Economist intelligence Unit (EIU), fears remain over the fact that growth of the downstream sector, one main pillar of the overall goal of diversification, will be hindered by the ongoing departure of illegal foreign workers, since November. Add to this, a new law was passed in December shortening the maximum working week for private-sector employees. This, in addition to a planned increase in minimum wage for Saudi workers, is expected to restrain companies' efficiency in 2014 and beyond.

1.2. EXTERNAL SECTOR

Falling current account contracting the balance of payments surplus

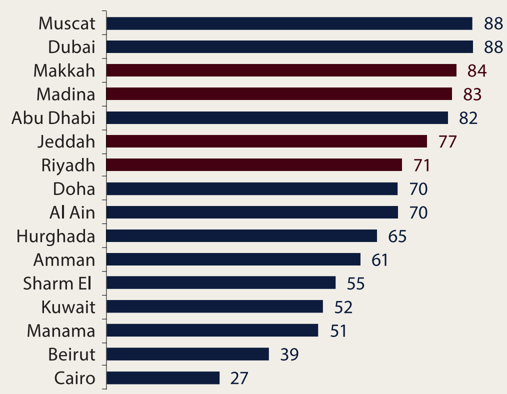
Lower oil production for the second consecutive year, coupled with almost stable prices, led to a weaker position on the external front. Indeed, after soaring in 2011 and then stagnating in 2012, the Kingdom external accounts regressed in 2013, yet managed to remain in positive territories. For instance, the trade surplus, stood at US$ 222.71 million in 2013, down by 9.7% from its 2012 level, as per SAMA. Consequently, the current account surplus accounted for 17.2% of nominal GDP in 2013, down from a share of 22.7% in 2012 and 23.7% in 2011.

On the trade front, overall activity in 2013 remained almost unchanged from that reported in 2012, where an 8.1% increase in the size of imports was just balanced by a 3.2% decrease in exports. In fact, exports in 2013 stood at US$ 375.93 billion, down from US$ 388.40 billion in 2012 and US$ 364.70 billion in 2011. Such a decrease in exports was mainly driven by a quantity effect. Indeed, while average oil prices in 2013 (US$ 103.15/ barrel) was 1.8% higher than the average reported in 2012 (101.34 US$/barrel), exports of mineral products, accounting for 86% of the total, were down by 4.6% in 2013, following a rise of 6.2% in 2012. Indeed, while exports of crude oil to Asia and the Far East, the commodity's largest importer,

EVOLUTION OF TOURISM ACTIVITY

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

COMPARATIVE HOTEL OCCUPANCY RATES*



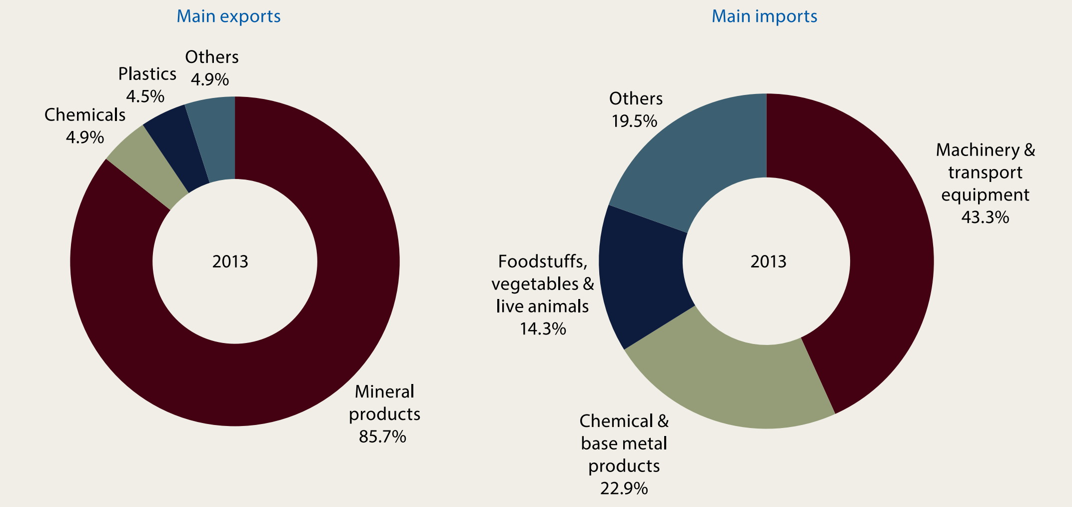
*First quarter of 2014

Sources: Ernst & Young, Bank Audi's Group Research Department remained almost unchanged over the year, those directed to North America reported an increase of 2.2%, while those directed to Western Europe and the Middle East reported respective declines of 4.2% and 3.3%. Non-oil exports, accounting for 14% of the total, recorded a rise of 6.0% in 2013 following a higher one of 8.4% in 2012. The slowdown within this category was mostly attributed to the weaker growth of exports at the level of chemical products, which edged up by 2.6% in 2013, a rate much lower than that of 9.3% recorded in 2012. Also, food products reported a negative growth of 1.7% in 2013, while they registered a positive one of 2.0% in 2012.

Imports amounted to US$ 168.18 billion in 2013, rising by 8.1% from 2012, year during which they increased by 18.2%. While all imports' categories managed to report positive growth, the breakdown of imports shows that the slowdown was mainly driven by weaker growth in imports of chemical products and related industries (8% of the total), of textile and textile products (3% of the total), of electrical equipments (26%), and metals and metal products (12%) and transportation equipments (17%).

The slowdown in exports, along with a rise in imports, has driven the trade surplus to shrink by 10.8%. With regards to the financial account, the surplus grew by 6.5% to US$ 13.2 billion in 2013, mainly driven by lower incurrence of liabilities in direct investment as well as net acquisition of financial assets in portfolio and other types of investments. Overall, the balance of payment surplus recorded a decrease, from US$ 164.7 billion in 2012 (22.4% of GDP), to US$ 129.8 billion in 2013 (17.4% of GDP), according to data by the IMF.

EXPORTS AND IMPORTS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

1.3. PUBLIC SECTOR

Lowest fiscal surplus in three years on lower oil revenues and higher capital expenditures

Saudi Arabia's fiscal performance in 2013 was underpinned by a decline in revenues for the first time since 2009 due to lower oil revenues, while expenditures gathered pace driven by high capital spending on large projects. Within this context, the Kingdom's fiscal surplus witnessed in 2013 its first contraction in three years. In parallel, the country's gross public debt pursued its downward trajectory to reach its lowest level ever of 2.7% of GDP at end-2013, as per SAMA.

In details, fiscal revenues totalled US$ 308.4 billion during the year 2013, moving down by 7.3% from 2012, and reversing the upward trend that was prevailing since the year 2010. The fall in revenues is mainly driven by a 9.6% drop in oil revenues (accounting for 89.5% of the total) due to lower oil prices and production. Non-oil revenues reached an all-time high of US$ 32.4 billion in 2013, up by 18.3% relative to the previous year, partly due to labour registration fees.

Total government expenditures, originally budgeted at US$ 218.7 billion, rose by 11.8% in 2013 to attain a total of US$ 260.3 billion, following a rise of 5.6% in 2012, with the increase concentrated in capital spending and supply and services payments. Capital expenditures, which account for 32.0% of total spending, grew by a significant 19.2% in 2013 to reach US$ 83.2 billion as the government pushed contractors to finish projects that had been delayed. In parallel, current expenditures increased by 8.6% in 2013 to reach US$ 177.1 billion. The increase is mainly driven by a staggering rise in supplies and services of 46.2% that was mainly due to nonrecurring expenditures. Operations and maintenance were the other main area of spending growth (+12.7%).

Accordingly, the Kingdom's surplus fell by 51.8% to reach US$ 48.1 billion in 2013, its lowest level in three years, accounting for 6.4% of GDP, as per SAMA. In parallel, Saudi Arabia's gross public debt declined further to reach US$ 20.0 billion at end-2013 following the redemption of US$ 6.3 billion in government debt.

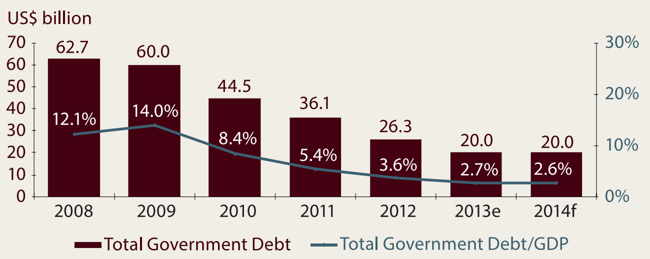
In parallel, Saudi Arabia set its 2014 budget spending at a record of US$ 228 billon, equal to the country's projected revenues. That spending figure marks a modest rise of 4.3% on planned spending in 2013 (US$ 219 billion), which is the slowest spending growth in a decade, suggesting that the Kingdom is starting to curb expenditures. The breakdown of expenditures by category shows that the Defence and National Security category is expected to register the highest growth of 20.5% in 2014 relative to the planned spending in 2013, noting that this category has expanded by a CAGR of 18.5% since the eruption of the regional turmoil in 2011, partly due to a US$ 30 billion deal sealed at end-2011 to buy US jets. This was followed by a 15.7% rise in the infrastructure development category in 2014 budget, health and social development with 10.2%, and municipality services with 9.1%. In the revenues side, total revenues are expected to grow by 3.1% in 2014 budget, with the rise in oil revenues estimated to account for 30.8% of total growth.

SELECTED PUBLIC FINANCE INDICATORS

US$ billion	2009	2010	2011	2012	2013e	2014f
General government revenues	154.3	219.2	318.2	368.8	330.8	329.3
General government revenues/GDP	36.0%	41.6%	47.5%	50.3%	44.4%	42.6%
General government expenditures	171.8	208.1	237.8	261.7	269.1	274.1
General government expenditures/GDP	40.0%	39.5%	35.5%	35.7%	36.1%	35.5%
General government fiscal balance	-17.5	11.1	80.4	107.1	61.7	55.2
General government fiscal balance/GDP	-4.1%	2.1%	12.0%	14.6%	8.3%	7.1%

Sources: IMF, Bank Audi's Group Research Department

PUBLIC INDEBTEDNESS AND DEBT RATIO



Sources: IMF, Bank Audi's Group Research Department

In the coming period, the fiscal surplus is expected to decline further in 2014, according to the IMF, as government spending increases. It is therefore important to slow the growth of government spending. The substantial fiscal buffers that the government has accumulated over the past decade already provide important protection to the economy in the event of a negative shock such as a fall in oil prices, and should be maintained. In addition, the Saudi authorities have initiated actions to strengthen the fiscal framework and they are encouraged, as per the IMF, to build on this progress to further reform the annual budget, introduce a medium-term budget framework, and develop tools to manage the volatility of oil revenues.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Stability in policy rates amidst a contained level of inflation

Monetary conditions in Saudi Arabia were characterized by a relatively eased inflation during the first quarter of 2014, a firm stability in key policy rates, an extended growth in SAMA's reserve assets to reach a new record high level at end-March 2014, and a moderate rise in monetary aggregates.

In details, Saudi inflation remained relatively contained during the first quarter of 2014, with the cost of living index increasing by 2.8% on average over the said period after rising by 3.5% on average in 2013. The relative slowdown in inflation is mainly driven by a decline in food inflation. In fact, the 3.8% year-on-year rise in food and non-alcoholic beverages prices in March 2014 was the lowest in 19 months. Within this context, the IMF expects an average inflation rate of 3.0% in 2014 as compared to 3.5% in 2013, though the tightening of the Saudiisation program remains a concern, and there is a risk that subsidy reform could have a knock-on impact on prices.

The breakdown of the cost of living index by category during the first quarter of 2014 shows that the Tobacco segment rose by 6.3% on average, followed by the Furnishings, household equipment & routine household maintenance segment with +6.0%, the heavyweight food and non-alcoholic beverages segment with +4.5%, the housing, water, electricity, gas, and other fuels segment with +3.9%,the recreation and culture segment with +3.8%, the education segment with +3.7%, the health segment with +3.2%, the restaurant and hotels segment with +3.0%, and the communication segment with +0.3%. In contrast, the transport segment declined by 2.5% on average during the first quarter of 2014, followed by the miscellaneous goods and services segment with -0.2%, and the clothing and footwear segment with -0.1%. It is worth mentioning that the total influence ratio of three segments on the cost of living index, namely the housing, water, electricity, gas, and other fuels segment, the household equipment & routine household maintenance segment, and the communication segment, reached 70.7% during the first quarter of 2014 as compared to a total influence ratio of 49.1% during the corresponding period of 2013, as per SAMA.

Within the context of a relatively contained level of Saudi inflation, SAMA kept its repo rate at 2.0% since January 2009 and its reverse repo rate at 0.25% since June 2009. SAMA considers the current central bank policy rates as reasonable and balanced, and highlighted that tapering of the US Federal Reserve's bond purchases is unlikely to affect the central bank's monetary policy.

The narrow measure of money supply (M1) widened by 6.1% (the equivalent of US$ 16,374 million) during the first quarter of 2014 to reach US$ 283 billion, following a 12.8% surge in 2013. The growth in M1 was driven by a 6.8% rise in demand deposits and a growth of 2.5% in currency outside banks during the first quarter of 2014. The broader Money Supply (M2) expanded by 4.8% during the said period to reach US$ 376 billion, after an 11.1% growth in 2013. Finally, money supply in its broadest sense (M3) widened by 4.9% during the first quarter of 2014 (the equivalent of US$ 20,144 million) to reach US$ 432 billion, after rising by 10.9% in 2013. Given the relatively higher growth in demand deposits during the first quarter of 2014, the demand deposits to broader money supply (M3) ratio moved up from 55.5% at end-December 2013 to 56.5% at end-March 2014, and the M1/M3 ratio rose from 64.7% to 65.5% over the same period.

SAMA's reserve assets actually grew by 1.1% during the first quarter of 2014 after surging by 10.5% in 2013, to reach a new record high level of US$ 733.7 billion at end-March 2014, mainly driven by a 3.6% increase in investment in foreign securities, noting that this category represented 73.3% of SAMA's reserve assets at end-March 2014. The continuous rise in SAMA's reserve assets reflects the fact that the country has been generating an external account surplus in view of rising oil production, as disruptions to Libyan oil production have provided Saudi Arabia with a chance to step up its output. Accordingly, SAMA's reserve assets covered 195.1% of Money Supply in Saudi Riyal at end-March 2014, down from 202.3% at end-2013.

Looking forward, SAMA is set to pursue monetary policy aimed at achieving financial and price stability, supporting the various economic sectors in line with domestic and international economic developments and supporting domestic banks to perform their financing role in the domestic economy. Exchange rate targeting remains the principal monetary policy objective, complemented by an operational focus on system liquidity and the goal of maintaining price and financial stability. The peg to the US Dollar continues to provide credibility to monetary policy and stability to trade, income flows, and financial wealth given the dominance of US Dollar-denominated oil products in exports and the high share of US Dollar-denominated external assets, according to the IMF.

1.4.2. Banking Activity

Continuously solid activity growth and financial soundness indicators

Saudi banks continue to benefit from the overall stability in politico-security conditions and the government spending drive that spurred healthy economic growth rates throughout the year 2013 and so far this year. Total assets of banks operating in the Kingdom rose by 9.2% last year and by a further 5.1% in the first three months of 2014 to reach the equivalent of US$ 530.8 billion at end-March 2014.

Total deposits at Saudi banks remained the main source of funding in the sector, accounting for about three quarters of total balance sheets at end-March 2014 and thus constituting the main activity driver of the sector. Total deposits registered an 11.2% yearly growth in 2013 and another 5.1% increase in the first quarter of this year to reach US$ 393.1 billion at end-March 2014. The rise in deposits at banks was registered amid healthy economic activity across the Kingdom in the covered period fostering a rise in corporate revenues and individual income translating into higher funds parked at banks, all the more so they have well established deposit franchises across the Kingdom.

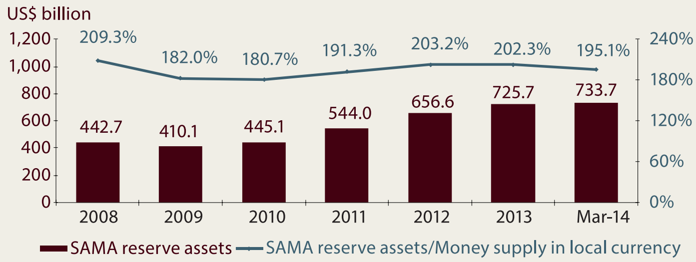
A closer look at total deposits by type shows that while all major components posted increases throughout last year and in this year's first quarter, the bulk of the growth was favored by higher demand deposits on behalf of the private sector (retail and corporate deposits) which were responsible for three quarters of total deposit growth both in 2013 and in the first three months of this year. While deposits at banks in Saudi Arabia continue to increase, the sector is characterized by a relatively high concentration in deposits.

EVOLUTION OF MONETARY SITUATION

Variation (US$ million)	2009	2010	2011	2012	2013	Q1-14
Net foreign assets	**-14,015**	**31,644**	**104,111**	**112,439**	**69,886**	**11,373**
SAMA	-32,605	35,061	94,817	112,396	69,126	7,898
Commercial Banks	18,591	-3,417	9,294	43	761	3,474
Domestic Assets	**-15,995**	**19,607**	**20,776**	**40,504**	**47,101**	**19,922**
Claims on private sector	-85	11,072	22,029	37,537	33,205	11,473
Claims on public sector	-14,862	7,429	-1,132	899	12,685	8,428
Claims on Nonfinancial Public Sector Enterprises	-1,048	1,106	-121	2,068	1,211	22
Broad Money (M3)	**26,619**	**13,714**	**38,185**	**45,384**	**40,372**	**20,144**
Money Supply (M1)	25,617	27,742	36,105	33,635	30,222	16,374
Quasi-Money	1,002	-14,029	2,080	11,750	10,150	3,770
Government Deposits	**-35,424**	**18,518**	**51,850**	**87,666**	**33,279**	**-7,425**
Other Items (Net)	**-21,204**	**19,020**	**34,852**	**19,892**	**43,336**	**18,575**

Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

FOREIGN EXCHANGE MARKET INDICATORS



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

As Moody's noted, the top 20 depositors account for around a third of total deposits. Nonetheless, since the majority of the largest deposits are from government related entities, the funding base is viewed as relatively stable given those funds' high correlation to the government's strong fiscal position.

The higher liquidity at hand for banks in the Kingdom, coupled with ongoing government spending and increasing customer needs for financing in a growing economy amidst an overall improved business climate, lead to a healthy increase of 12.5% year-on-year in claims on the private sector followed by a further growth of 3.8% in the first quarter of 2014 to total US$ 311.1 billion at end-March 2014. Similarly, bank claims on the public sector in its government and quasi-government components rose by 23.6% in 2013 and continued its solid progression this year with an 11.6% increase in the first quarter. This occurred as banks slightly increased their lending to public sector enterprises but mostly as they accentuated their investments in government securities, in particular Treasury bills.

The distribution of bank credit by maturity shows that in the 15 months to March 2014, about half of the credit volume increase was due to an increase in those with long-term maturities which increased their share in the total from 26% at end-2012 to 30% at end-March 2014. Banks' continued extension of their credit maturity curve sheds light on the banking sector's widening asset liability maturity gaps. As a matter of fact, the predominance of demand deposits, which represent around 62% of the total deposit base, entails a non-negligible reliance on short-term funding sources to finance longer-term lending. However, local short-term deposits proved rather stable in recent years, which somewhat attenuates the asset liability mismatch risk. Anyhow, local authorities are addressing this issue with the setting up of a government-owned securitization company that would help tackle the asset-liability mismatch for local banks owed to higher mortgage lending funded mainly by short-term deposits, as per Fitch.

While the wave of lending to the real economy has bolstered banks' financial intermediation role and contributed to boosting economic activity in the Kingdom, they still enjoy further room to extend credit. In fact, the loan (excluding investment in securities) to deposit ratio remains below the 80% mark and, as such, under the 85% ceiling set by the SAMA. The Kingdom's banks also benefit from an adequate liquidity stance. Banks' primary liquidity, i.e. reserves and placements with banks in the Kingdom and abroad, reached 19% of their total deposits at end-March 2014. When adding investments in government securities, liquid assets account for close to 37% of the banks' total deposit base, thus enabling them to match potential liquidity needs and leave room for additional lending activity in the period ahead.

BANKING SECTOR RATIOS

US$ million	2008	2009	2010	2011	2012	2013	Mar-14
Banking sector dimension in economy							
Assets/GDP	66.8%	85.2%	71.6%	61.5%	63.0%	67.7%	70.6%
Deposits/GDP	43.4%	58.5%	49.9%	44.0%	45.8%	50.2%	52.3%
Loans to private sector*/GDP	36.6%	44.0%	37.6%	32.9%	34.9%	38.5%	39.6%
Growth rates (YTD)							
Assets	21.1%	5.2%	3.3%	9.1%	12.3%	9.2%	5.1%
Loans to the private sector*	27.9%	-0.6%	4.8%	11.0%	16.4%	12.1%	3.8%
Investments	21.4%	-2.1%	11.3%	1.6%	1.0%	16.9%	10.7%
Deposits	17.9%	11.2%	4.7%	12.1%	14.2%	11.2%	5.1%
Capital and reserves	24.3%	24.1%	8.8%	6.8%	10.2%	7.8%	14.4%
Profit growth (year-on-year)	-1.1%	-10.4%	-2.6%	18.4%	8.4%	6.5%	10.6%
Financial ratios							
Primary liquidity/Deposits	19.6%	25.6%	22.6%	22.5%	23.5%	19.5%	19.1%
Loans to the private sector*/Deposits	84.2%	75.4%	75.4%	74.7%	76.2%	76.8%	75.8%
Capital accounts/Assets	12.4%	13.9%	14.4%	14.3%	14.0%	13.8%	13.5%
ROAA	2.52%	2.01%	1.88%	2.09%	2.04%	1.97%	2.12%
ROAE	20.08%	15.23%	13.24%	14.54%	14.44%	14.15%	15.53%

* Excluding investments in private securities

Sources: Saudi Arabian Monetary Agency, IMF, Bank Audi's Group Research Department

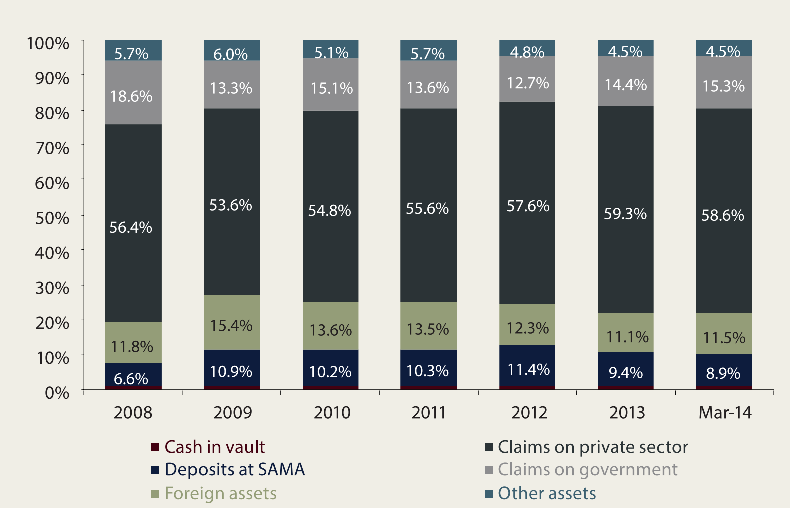
On another note, banks' rising lending activity, particularly aimed at the public sector in the form of subscriptions to government securities, highlights a growing exposure to the sovereign. The latter reached 0.97x total capital accounts at end-March 2014, against a lower 0.87x at end-2013 and 0.75x at end-2012. But with the strength of the Saudi government balance sheet and comfortable fiscal and external accounts, sovereign exposure is not a pressing concern for banks operating in the Kingdom.

The increasing lending activity in general triggered a favorable quantity-effect which, coupled with a low-cost funding structure (given the high proportion of non-interest bearing demand deposits) and operational efficiency with zero corporate tax rates, offset ongoing margin pressure in the relatively low interest rate environment that has been prevailing in the post-global crisis outburst period. Banks' interest margin to gross income ratio was maintained in the 65%-66% range last year, and growing lending volumes along with lower needs for provisioning last year, helped banks register a healthy increase in their bottom lines. As a matter of fact, Central Bank figures indicate a 6.5% yearly rise in sector profits last year, followed by a further 10.6% year-on-year increase in the first quarter of this year. As such, profitability ratios remain comfortable in both absolute terms and relative to regional and international averages, with the annualized return on average assets ratio at 2.1% and the annualized return on equity ratio at 15.8% in the first quarter of 2014, despite the strong growth in balance sheet aggregates.

Saudi banks' high profitability is likely to continue driving healthy internal capital generation. The sector remains well capitalized despite strong asset growth. The sector-wide regulatory capital to risk-weighted assets ratio stood at a solid 17.9% at end-December 2013 as per the latest available figures, almost maintaining its previous years' levels, noting that the bulk of regulatory capital actually consists of Tier 1 capital. The IMF said that authorities noted that the Kingdom was among the first countries to implement Basle III capital standards, and saw no difficulties for banks in meeting capital, liquidity and leverage ratios set out by the Basle committee.

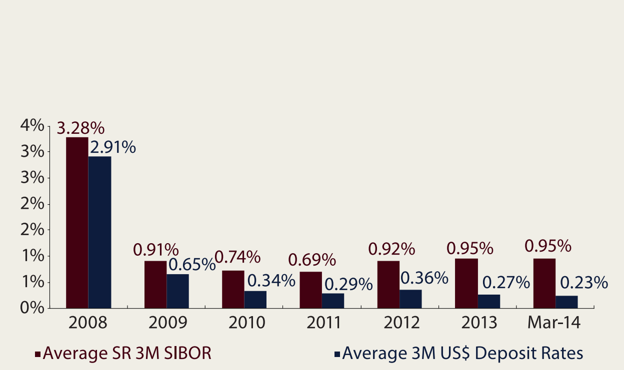
In parallel, banks continue to enjoy strong asset quality metrics. The non-performing loans to total gross loans ratio reached a post-global crisis low of 1.3% at end-December 2013, depicting a steady yearly decline over the past few years (1.9% at end-2012 and 3.3% at end-2009). NPLs remain comfortably covered, with the provisions to NPLs ratio at 157.4% at end-2013 (145.1% at end-2012) as per the IMF. Those ratios are likely to remain favorable on the overall amidst positive macroeconomic conditions, ameliorating underwriting standards and government related project lending, as banks seize the opportunity to act as a partner to the real sector in the development of the domestic economy in the period ahead.

BANKING SECTOR ASSET COMPOSITION



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

BANKING SECTOR INTEREST RATES



Sources: Saudi Arabian Monetary Agency, Bank Audi's Group Research Department

1.4.3. Equity and Bond Markets

Favourable momentum and price rises in Saudi capital markets

Saudi capital markets enjoyed a favourable momentum during the first four months of 2014. The equity market continued to take comfort from massive spending plan on infrastructure projects and growth in banking sector's bottom lines, defying the general slowdown in emerging market bourses (-0.3% as per S&P). The fixed income market benefited from its safe-haven status amidst lingering concerns about Ukraine's unrest, which contributed to attracting a decent bid and registering further contractions in the cost of insuring debt.

The Saudi Tadawul saw a rise in activity and prices during the first four months of 2014, benefiting from improved investor sentiment as the government pursues a massive spending plan to boost the non-oil economy, in addition to favourable financial results, a shift from Saturday-Wednesday working week to Sunday-Thursday that has helped aligning Saudi financial markets more closely with trading hours in the rest of the world, and speculation about plans to open-up the Saudi stock exchange to foreigners.

The Tadawul All-Share Index (TASI) closed at 9,585.22 at end-April 2014, up by 12.3% since year-end 2013, following a surge of 25.5% in 2013, driven by some favourable 2013 full-year results and 2014 first quarter results, in addition to speculation that Saudi authorities may open up the market to foreigners, a long-awaited move that would contribute to attracting additional inflows. In details, listed banks announced aggregate net profits at SR 35.7 billion for 2013 against SR 33.5 billion for 2012, up by 6.5%. Also, they posted a 10.6% year-on-year increase in their 2014 first quarter net profits to reach SR 10.3 billion. At the level of market pricing ratios, the P/E ratio stood at 16.57x at end-April 2014 as compared to a P/E of 16.0x in the MENA region and a P/E of 11.0x in emerging markets.

The breakdown of the TASI by sector during the first four months of 2014 shows among others that the media and publishing sector reported the highest index surge with +67.9%. The second best performer is the real estate development sector with +39.1%, then followed by the hotel & tourism sector with +38.1%, the transport sector with +33.2%, the retail sector with +32.1%, the building and construction sector with +24.7%, the multi-investment sector with 19.8%, the industrial investment sector with +19.6%, the agriculture and food industries sector with +18.8%, the insurance sector with 16.2%, the telecommunication & information technology sector with +14.7%, the cement sector with +7.0%, and the banks and financial services sector with +6.8%.

Alongside the rise in the Tadawul All Share Index, the number of listed companies rose from 163 companies at end-2013 to 164 companies at end-April 2014. Within this context, the market capitalization moved up by 11.4%, from US$ 467.4 billion at end-2013 to US$ 520.7 billion at end-April 2014 after rising by 25.2% in 2013. The market capitalization represented 69.0% of GDP at end-April 2014, up from 62.7% in 2013, which reflects the rising dimension of the Tadawul in the Saudi economy.

The total trading value amounted to US$ 186.9 billion during the first four months of 2014, surging by 36.6% relative to the corresponding period of the previous year. The division of the total trading value by category during the first four months of 2014 showed that the insurance sector captured 18.2% of activity, followed by the petrochemical industries sector with 13.1%, the agriculture and food industries sector with 10.0%, the industrial investment sector with 8.8%, the real estate development sector with 8.5%, the banking & financial services sector with 7.7%, the telecommunication & information technology sector with 6.9%, the retail sector with 6.4%, the building & construction sector with 6.3%, the cement sector with 2.6%, the multi-investment sector with 4.4%, the transport sector with 3.2%, the hotel & tourism sector with 2.1%, the media & publishing sector with 1.2%, and the energy & utilities sector with 0.7%. Given a substantial rise in the total trading value and a lower increase in the market capitalization over the first four months of 2014, the annualized turnover ratio stood at 107.7% during the first four months of 2014 as compared to 106.5% during the corresponding period of 2013.

It is worth noting that the bulk of trading continues to be dominated by local individuals and institutions, with more than 90% of trading conducted by Saudis. This highlights the need for further foreign exposure in the local market, which will certainly develop the market and add depth. In fact, foreigners –excluding GCC nationals– are currently only allowed to invest in the local market through equity swaps and exchange-traded funds. Yet, a decision to open-up the market to foreigners has not been made yet as the market's volatility remains a concern. Within this context, it is worth mentioning that the Capital Market Authority has imposed a series of regulatory changes to make the Kingdom's stock market less volatile and more transparent. Those measures have ranged from capping price changes of stocks on their first day of trading to requiring listed companies to promptly report any plant shutdowns or other news that might impact their bottom line.

As to fixed income markets, Saudi debt papers were on the investors' radar screen so far in 2014 as the Kingdom has cemented itself as a solid economy while embarking on strong expenditures to further enhance economic activity, and as unrest in Ukraine spurred demand for safety and investors weighed prospects for the US economy. SECO'22 and '23 closed up so far this year by 4.50 pts and 6.13 pts respectively. SECO'43 traded up by 8.38 pts. Prices of SABIC'18 and '20 increased by 2.00 pts and 3.88 pts respectively. Dar Al Arkan'16 and '18 were up by 3.50 pts and 4.50 pts respectively. Price of Banque Saudi Fransi'17 rose by 0.88 pt. At the level of the cost of insuring debt, Saudi Arabia's five-year CDS spread contracted by 10 bps so far this year to reach 45 bps, which is currently the lowest CDS level in the MENA region along with Abu Dhabi. This followed a 15 bps contraction in 2013.

As to sovereign credit ratings, Fitch upgraded in March 2014 Saudi Arabia's long-term foreign and local currency issuer default ratings to "AA" from "AA-", with "stable" outlook. The country ceiling was upgraded to "AA+" from "AA" and the short-term foreign currency IDR was affirmed at "F1+". The upgrade of Saudi Arabia's IDRs reflects the country's strong sovereign and external balance sheets. It also reflects the authorities' efforts to address unemployment and a shortage of affordable housing, both of which Fitch considers potential economic sources of social instability. The upgrade further reflects the improvement in the Kingdom's banking soundness indicators. The "stable" outlook reflects Fitch's assessment that upside and downside risks to the rating are currently well balanced.

In parallel, Moody's indicated that Saudi Arabia's "Aa3" government bond rating and "stable" outlook reflect the Kingdom's considerable economic and government financial strength. In recent years, windfall oil revenues have generated large fiscal surpluses, allowing the government to build a sizeable asset cushion and sharply reduce its debt ratios, to levels much lower than its peers, as per Moody's.

Regarding new bond issues, National Commercial Bank issued in February 2014 a SR 5 billion 5-year subordinated Tier II capital Sukuk that was priced at 110 bps over the six-month SIBOR. The transaction was the largest issuance by a financial institution in the Kingdom and falls within the trend of issuing debt instruments to boost capital reserves of Saudi banks. Also, Saudi Electricity Company raised in April 2014 US$ 1.5 billion from the sale of 10-year Sukuk at a yield of 4% and US$ 1 billion from the sale of 30-year Sukuk at a yield of 5.5%. Several new debt issues are currently waiting in the pipeline. In fact, Saudi Telecom Company, Dar Al Arkan Real Estate, ACWA Power, Banque Saudi Fransi announced plans to sell debt papers.

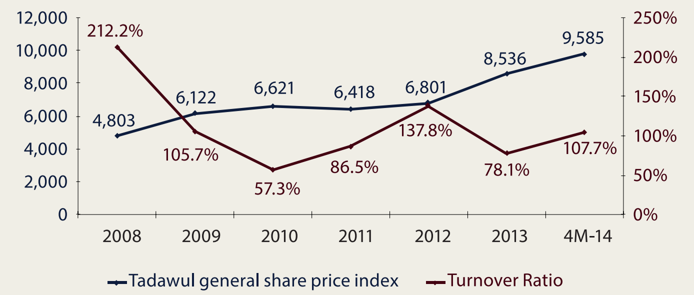
Looking forward, with ample liquidity in the Saudi market often suppressing borrowing costs to levels well below rates for equivalent US Dollar-denominated bond sales, Saudi firms are likely to favour the local debt market over international bond issues to meet their financing requirements.

SELECTED STOCK MARKET INDICATORS

	2009	2010	2011	2012	2013	Apr-14
Market capitalization (US$ billion)	318.9	353.3	338.9	373.3	467.5	520.7
Market capitalization/GDP	74.3%	67.1%	50.6%	50.9%	62.7%	69.0%
Trading value (in US$ billion)	337.1	202.4	293.0	514.5	365.2	186.9
Number of transactions (in millions)	36.5	19.5	25.6	42.1	29.0	3.9
Number of listed companies	135	145	150	158	163	164
Change in share price index	27.5%	8.2%	-3.1%	6.0%	25.5%	12.3%
Price/Earnings ratio	18.0x	15.2x	12.3x	12.9x	15.2x	16.6x
Price/Book value ratio	2.0x	2.1x	1.8x	1.8x	2.2x	2.3x

Sources: Tadawul, IMF, Bank Audi's Group Research Department

CAPITAL MARKETS PERFORMANCE



Sources: Tadawul, Bank Audi's Group Research Department

2. CONCLUDING REMARKS

Looking ahead, what is the outlook for the Kingdom in the foreseeable future? What are the challenges to such an outlook? How do fundamental strengths compare to the key challenges of the Saudi economy?

In 2014, it is expected that the improved performance evident in the second half of last year will be maintained, as the impact of the massive outflow of expatriates in 2013 dissipates and oil production remains robust. This should be sufficient to push real GDP growth slightly higher to 4.1% this year, although this is far below the stimulus-fuelled growth rates seen in 2011 and 2012. Double digit current account surpluses are still expected for 2014 and 2015, with the IMF forecasting them at 15.8% and 13.3% respectively.

It is worth noting that after several years of expansionary state spending, the government passed a considerably more austere budget for this year, with total spending budgeted to rise by just 4.3% in 2014, compared with increases of 17% in 2013 and 19% in 2012. With that in mind, 2014 should provide a revealing insight into the country's future growth potential, as the economy begins its process of rebalancing away from the government.

At the monetary level, the Saudi Riyal's peg to the US dollar, which has been in place since 1986, is almost certain to remain unchanged at SR 3.75/US$ within the context of the strong foreign assets of the Kingdom and sustained fiscal and current account surpluses. Equally, the long proposed single GCC country in not expected to be set up in the next few years, As a result, the riyal will track movements in the US currency, which is expected to strengthen steadily over the years to come as the Federal Reserve tightens its monetary stance.

At the top of challenges lying ahead is that economic performance continues to be heavily dependent on oil, which accounts for around half the economy and the bulk of fiscal and external receipts. Substantial external buffers can temper the impact of swings in oil revenues, but the rise in fiscal breakeven oil price (to an estimate of US$ 84/barrel in 2013) points to challenges ahead. It is expected that a narrowing of the general government surplus would see the light in 2014 and 2015, though spending growth is expected to be lower than in recent years as capital spending is likely to have peaked in 2013.

If we were to summarize the main strengths and weaknesses of the Kingdom's economy in a nutshell, we would deduce that strengths outpace challenges looking ahead. At the level of strengths, we mention the very low government debt, the high external liquidity, the geostrategic importance of the Kingdom as the lynchpin of OPEC and the prudent financial system regulation. At the level of weaknesses, we mention the relatively high unemployment, the narrow tax base vulnerable to oil price volatility and the regional geopolitical threats. Looking ahead, the risk outlook could improve on the back of further improvements in institutional strength, more progress on economic diversification which cushions vulnerability to oil price volatility and a reduction in regional political and security threats.

According to the IMF last Article IV Consultation Mission report, maintaining macroeconomic stability and achieving development goals will require vigilance toward possible overheating risks, continued strong financial supervision, and fiscal reforms. The macroeconomic policy stance appears appropriate at present, although the authorities will need to remain vigilant and adjust policy settings if overheating pressures were to emerge. Measures to promote financial development should continue to be supported by strong regulation and supervision. While large fiscal buffers give the authorities the fiscal space to smooth government spending over the medium-term in the face of volatile oil revenues, fiscal reforms to further develop budget management and ensure the quality of spending could help achieve development goals at large.

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