Executive Summary

Over the past four decades (1970–2012), Saudi Arabia has witnessed considerable change in the economic, social, and urban aspects of life. The average Saudi per capita income has increased from about SAR 5,373 in 1971 to about SAR 91,332 in 2012. This report focuses on analyzing the primary economic indicators for the Kingdom over the past four decades.

- During 1970–2012, KSA’s GDP expanded extensively, led by the oil sector, improving business environment, and channeling economic diversification through large investments in infrastructure. The IMF expects real GDP growth to remain healthy at around 4.2% during 2013–18.
- The government’s efforts toward diversification would lead to 5–6% growth in the non-oil economy in coming years. Growth would be driven by continued large fiscal spending, supportive monetary policy, and improving private sector business activities.
- KSA has historically utilized its oil revenues to diversify into non-oil sectors. The country would continue to have a budget surplus between 2013 and 2017, supported by higher oil prices.
- Inflationary pressures in the country are likely to remain subdued in the coming years. However, government’s efforts to improve employment could drive inflation up in the near term.

Saudi GDP – drifting away from oil

Over the past few decades, Saudi Arabia's GDP has witnessed extensive growth, led by the oil sector, improving business environment, and channeling in economic diversification through large investments in infrastructure. For simplifying our analysis, we divided the real GDP growth into four phases:

- **Phase 1 from 1970 to 1980:** During the 1st phase, real GDP recorded a GAGR of 11.5%, supported by strong growth in construction and financial services sectors. During the period, these sectors witnessed 10.3% and 15.0% growth, respectively. Oil GDP grew at 9.9% supported by 27.3% rise in oil prices over the same period. The rise in oil prices was primarily driven by the oil embargo, wherein members of the Organization of Arab Petroleum Exporting Countries imposed an export restriction against the United States and other countries supporting Israel, including the Netherlands, Portugal, and South Africa. This restriction commenced during October 1973 and lasted until March 1974. On October 16, 1973, OPEC announced its decision to raise oil prices by 70% and reduce production by 5% from the September’s output level. Furthermore, during this phase, oil prices were impacted by the second oil crisis (1979 – Iranian Revolution), with cut down in production and suspension of exports by Iran's oil sector.

- **Phase 2 from 1981 to 1990:** Oil prices peaked in 1980–81 and later declined rapidly on account of slowdown in economic activity in industrial countries and surplus availability of oil. Saudi oil production, which had increased to almost 10 mn bbl/day during 1980–81, dropped to about 2 mn bbl/day in 1985. Real GDP contracted 1.2% over this decade, with oil GDP contracting 3.9%. Oil prices declined 8.7% over this period. During 1990, prices had risen 23.6% YoY on account of the Gulf war when Iraq invaded Kuwait.

- **Phase 3 from 1991 to 2000:** GDP Growth improved during this phase, supported by improvement in oil and manufacturing sectors. Oil prices rose 2.9% over this period.

- **Phase 4 (2001 to 2012):** Saudi Arabia’s real GDP expanded at an annual rate of 6.1% over 2001–12 on record oil prices, high fiscal spending, current account surpluses, and improving business environment. Oil prices increased at 12.8% over this period. During this phase, the Kingdom witnessed the sharpest global economic downturn since World War II and growth was significantly impacted, slowing down to 1.8% in 2009. However, Saudi Arabia’s GDP growth bounced back to a robust average annual rate of nearly 7% over 2010–12.

Nominal GDP witnessed a similar trend as real GDP. However, the gap between the two has widened significantly over the past decade, considering the phenomenal rise in oil prices.

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1. Arabian Light real oil prices
2. Consisting of the Arab members of OPEC, plus Egypt, Syria and Tunisia
Comparison with other GCC countries, MENA, and developing and developed nations

Real GDP of KSA averaged ~6.3% over 2008–12, benefitting from high oil prices, strong private sector activity, and government fiscal spending. The oil sector witnessed 2.6% growth, whereas the non-oil sector recorded average growth rate of 7.5%. Compared to its regional peers, it registered the second-highest growth after Qatar.
Outlook – growth to remain healthy, supported by non-oil growth

KSA’s real GDP growth is likely to remain healthy at around 4.2% over 2013–18 despite falling crude oil demand and oil prices. GDP growth in the coming years would be driven by the government’s expansionary fiscal stance and a resilient non-oil private sector. The IMF expects the potential growth rate of KSA’s non-oil economy to be around 5–6% over the coming years, driven by continued large fiscal spending, supportive monetary policy, and improving private sector business activities. The Kingdom’s real GDP is estimated to grow 3.6% in 2013 and 4.4% in 2014, and thereafter at 4.3% during 2015–18.

Diversification into non-oil sector to aid stability in growth

The sharp decline in oil prices witnessed in the early 1980s and the heightened volatility of oil prices during 1986–1990 shifted the KSA government’s focus toward diversification in order to counteract income fluctuations. Non-oil real GDP in the Kingdom expanded at a CAGR of 0.4% during 1981–90 vis-à-vis 7.2% over 2000–12. Furthermore, the proportion of its share in overall real GDP improved significantly from 45% in 1970 to 79% in 2012. Growth has been led by strong industrial and service sectors. Diversification into non-oil sector is expected to aid stability and sustainability in growth.
The government has taken various measures to reduce its dependence on oil. Since the beginning of the development plans, key policy objective has been diversification of the economy. The first development plan in 1970 focused on diversification (apart from building infrastructure and developing the human resources) and explicitly enunciated the general objective of "diversifying the national income sources and reducing dependence on oil through enhancing contribution of other producing sectors in GDP."

Over the past few decades, focus has shifted toward non-oil sectors such as manufacturing, retail, transportation & communication, and other infrastructure sectors (electricity, gas, and water). The manufacturing sector contributed ~4% to GDP in 1980 vis-à-vis the 10% contribution in 2012. Similarly, the contribution of wholesale & retail trade (up from 4% in 1980 to 8% in 2012) and transportation & communication (up from 2% in 1980 to 5% in 2012) to GDP has more than doubled in the last four decades.

**Figure 6: Real GDP constituents (CAGR)**

<table>
<thead>
<tr>
<th>Sector</th>
<th>2001-2012</th>
<th>1990-2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trans. &amp; Comm.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale &amp; Retail Trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity, Gas &amp; Water</td>
<td></td>
<td></td>
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<tr>
<td>Other Manufact.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fin., Ins. &amp; RE</td>
<td></td>
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</tr>
<tr>
<td>Construction</td>
<td></td>
<td></td>
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<tr>
<td>Community, Personal</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mining &amp; Qua.</td>
<td></td>
<td></td>
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<tr>
<td>Agriculture</td>
<td></td>
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<tr>
<td>Petroleum Refining</td>
<td></td>
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</tbody>
</table>

**Figure 7: Change in contribution* to Nominal GDP**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td></td>
</tr>
<tr>
<td>Wholesale &amp; Retail Trade</td>
<td></td>
</tr>
<tr>
<td>Transport &amp; Comm</td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td></td>
</tr>
<tr>
<td>Electricity</td>
<td></td>
</tr>
<tr>
<td>Community &amp; Social</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td></td>
</tr>
<tr>
<td>Finance, Ins., RE</td>
<td></td>
</tr>
<tr>
<td>Mining &amp; Qua.</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 8: Nominal GDP constituents across various periods**

- **1980**
  - Mining: 13.9%
  - Manufacturing: 4.1%
  - Others: 7.1%
  - Wholesale & Retail Trade: 10.6%
  - Construction, Elec, Transport & Comm: 4.0%
  - Others: 6.4%
  - Mining: 4.0%

- **1990**
  - Mining: 9.7%
  - Manufacturing: 12.8%
  - Others: 6.4%
  - Wholesale & Retail Trade: 21.7%
  - Construction, Elec, Transport & Comm: 12.6%
  - Others: 8.6%

- **2000**
  - Mining: 9.7%
  - Manufacturing: 4.9%
  - Others: 8.2%
  - Wholesale & Retail Trade: 19.5%
  - Construction, Elec, Transport & Comm: 37.1%

- **2012**
  - Mining: 8.0%
  - Manufacturing: 1.9%
  - Others: 10.2%
  - Wholesale & Retail Trade: 14.7%
  - Construction, Elec, Transport & Comm: 46.9%

*Source: SAMA, AlJazira Capital*
Some of the sectors that have witnessed significant growth or have the potential for helping the country to diversify away from oil include:

- **Banking and Financial Services:** We believe that the growing demand for banking products owing to favorable demographics, rising per capita income, and increasing focus on Shariah-compliant products would support growth in this sector, driving non-oil sector growth. The Kingdom's banking sector has witnessed strong and continuous growth in the past 10 years, with total assets growing threefold from SAR 508bn to SAR 1,734bn. The Saudi banking sector's asset quality has consistently improved, with the NPL ratio at 1.9% in 2012 from the high of 3.4% in 2009, and significantly below the GCC average of 5.0%. Moreover, the conservative norms of SAMA have enabled Saudi banks to efficiently weather the financial turmoil in 2009. The Saudi banks' average Capital Adequacy Ratio of 18.7% is well above the CAR requirements of 8% under Basel II and 10.5% under Basel III. According to Thomson Reuters Global Islamic Asset Management Report 2014, Saudi Arabia is the second-largest market for Islamic funds and has AUM exceeding USD 6bn. Furthermore, according to the report, the largest number of funds were launched in 2013 and 20% of the issuances were in Gulf countries, primarily due to the large number of Saudi funds launched during the year.

- **Development of capital intensive sectors:** Capital intensive sectors such as Cement have developed at a very fast pace over the past few years in KSA. Cement consumption in KSA has increased from 15.9MT in 2000 to 53.0MT in 2012 – a CAGR of 10.6% during 2000–12. The industry benefits from low production costs on account of subsidized fuel from Saudi Aramco and enjoys higher margins as compared to the regional peers. Furthermore, the Kingdom has an extensive base of natural resources and unexploited deposits of phosphate, bauxite, base metals, precious and rare metals, tin, feldspar, and basalt.

- **Focus on tourism sector:** A part of the diversification strategy involved setting up of the Supreme Commission of Tourism in 2000 to develop, upgrade, and enhance the tourism sector in the Kingdom. Saudi Arabia possesses massive potential for tourism and religious pilgrimage, considering the location of the two holy mosques at Makkah and Madinah. Furthermore, the Kingdom has various infrastructure projects (airport expansion, railway projects) in pipeline, which would attract more tourists to these destinations.

- **Development of other services sector:** Developing sectors such as agriculture (animal production, poultry, and dairy products), trade, aviation, real estate, telecommunication and IT, healthcare, and education are key focal points for the government.

- **Increasing private participation:** Boosting Foreign Direct Investment (FDI) and strengthening the services and private sector would help the country in shifting its reliance on non-renewable resources. Saudi Arabian General Investment Authority (SAGiA), established in 2000, has undertaken various initiatives to increase private sector participation in the country. The Knowledge Economic Cities being developed in the country would create 20,000 jobs and develop accommodation for 150,000 people, and is expected generate about SAR 10bn per year into the region once it is completed by 2020. Private participation in healthcare, power, and aviation sectors, among others, has also picked up. According to World Bank report, KSA is the highest ranked country in the GCC at the 12th position out 183 countries in the Global ranking in the Ease of Doing Business.
Challenges in diversifying

Some of the challenges in diversifying away from oil sector include:

• Majority of the KSA government’s revenues come from the oil sector. During 2012, oil accounted for nearly 92% of the government’s revenues. The government is diverting these revenues toward infrastructure development in the country. Thus, any unanticipated fall in oil prices could severely dent business and market sentiment, derailing the potential economic growth.

• Slowdown in business activity or delay in implementation of government projects pose major risks to diversification

• Employments initiatives in the country (Saudization and Nitaqat), aimed to augment the employment of nationals in the private sector, have led to a shortage of workforce and have created a demand/supply gap in workforce the private sector.

• KSA has witnessed significant diminution in FDI inflows and inflows stood at USD 12.2bn during 2012. This could pose as a major roadblock in the country’s diversification efforts. However, the Kingdom accounts for 25.8% of the FDI inflows in the Middle East and remains the most attractive destination for foreign investment in the region.

• Political tension in the region could negatively impact investor sentiment and, in turn, FDI inflows and private participation in KSA.

Oil revenues – the driver for budget surplus

The revenues of Saudi Arabia’s government have been fluctuating over the past decades, primarily reflecting the volatility in oil prices. Revenues have increased at 29.7% over 2010–12, supported by a 30.7% increase in oil revenues. Expenditure, on the other hand, increased significantly after 2000, with rise in government focus on diversification. Over 2010–12, expenditure recorded a CAGR of 15.6%. The sectors that have received maximum allocation in the government expenditure include human resource development and infrastructure development. Furthermore, barring 2009, the economy had fiscal surplus in all years since 2003. Lower oil revenues in 2009 had led to a deficit.
Comparison across other countries

All the GCC economies (barring Bahrain) have fiscal surplus due to high revenues from the oil sector. Among the developed economies (mentioned in the chart below), Germany is the only country to have a fiscal surplus. Similarly, amongst the countries Asian economies, only Singapore has a fiscal surplus.
Comparison of the average fiscal deficit/surplus as a percentage of GDP in KSA with other regional peers, developing Asia, and advanced economies revealed that KSA has a significantly higher surplus vis-à-vis the developing and developed economies. Furthermore, government expenditure across countries had declined significantly during the financial crisis in 2009. However, expenditure in KSA has picked up since then.

**Figure 11: Fiscal (Deficit)/Surplus % of nominal GDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>KSA</th>
<th>MENA</th>
<th>Developing Asia</th>
<th>Advanced</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>-6.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>2002</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>2003</td>
<td>3.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>2004</td>
<td>6.0%</td>
<td>0.0%</td>
<td>-2.8%</td>
<td>-4.3%</td>
</tr>
<tr>
<td>2005</td>
<td>9.0%</td>
<td>0.0%</td>
<td>-2.8%</td>
<td>-4.3%</td>
</tr>
<tr>
<td>2006</td>
<td>12.0%</td>
<td>0.0%</td>
<td>-2.8%</td>
<td>-4.3%</td>
</tr>
</tbody>
</table>

Source: IMF, SAMA, MENA average is from 2001 onwards

**Figure 12: Government expenditure trend**

Inflation would not hinder growth prospects

Inflation in the Kingdom of Saudi Arabia is measured by the Cost of Living Index, which is composed of more than 400 items, with 1999 as the base year. Food and rental costs constitute a major proportion and together account for around 44% of the total index. KSA has historically experienced low and stable inflation. The economy’s cost of living index increased at an average rate of 0.6% over 1980–2000 and 0.5% during 2001–06. The fixed exchange rate system coupled with other factors, including moderate economic activity, easy availability of cheap imports, flexible labor markets, aided in moderate inflation over a long period of time.

**Figure 13: Inflation in KSA vis-à-vis M2 and nominal GDP – historical trend (% YoY)**

KSA’s inflation accelerated in 2007 and reached 4.1% YoY in 2007 and 9.9% YoY during 2008. The rise in inflation during 2007–10 was driven by several factors including rising housing cost, higher food prices, and global commodity prices. Moreover, the lack of affordable housing during 2007–10 led to a sharp increase in rents, driving inflation. Furthermore, some experts believe the weakening of the dollar (during 2007–08), which led to imported inflation, contributed to higher inflation. However, inflation concerns have eased in recent years. During 2011–12, average inflation was 4.8% vis-à-vis the 6.1% average during 2007–10.
KSAs historical inflation much lower than regional and global peers

Saudi Arabia has one of the lowest inflation rates as compared with its regional and global peers. The countrys average inflation during 1991–2000 was 0.9% vis-à-vis the GCC average of 2.1%. Similarly, average inflation of a few developing and advanced nations during the same period was 4.3%. However, in the last decade, higher inflation in KSA led to a relatively small gap between the countrys inflation and that of its regional peers. During 2001–12, average inflation in the Kingdom was 3.1% against that of other GCC countries at 3.5%.
Inflation to remain below 4% until 2018, in line with global inflation

The IMF expects inflation in the Kingdom to remain at an average level of 3.6% during 2013–18. This is consistent with the global average, while much lower than that of its regional peers (MENA) at 9.5%. Factors that could pressurize inflation in the near term include higher labor costs due to ongoing labor market reforms and continued growth in the non-oil sector. Furthermore, rising access to finance and implementation of mortgage law could also lead to an increase in demand for housing units and drive prices.

Unemployment remains a major challenge

Despite robust economic growth in the Kingdom, unemployment remains a major challenge for the country. The rate of unemployment for Saudi nationals increased from 8.1% in 1999 to 12.1% in 2012, higher than the past 10-year average of 11.0%. However, the overall unemployment rate was 5.5% in 2012, led by lower levels of unemployment in expats. The unemployment rate for expats was 0.1% in 2012, lower than 0.6% during the past 10 years. The higher rate of unemployment among Saudi nationals is largely due to imbalance in demand and supply arising from mismatch between labor force expertise and jobs available.
Saudi nationals represent the majority of public sector workforce, whereas expats hold a major proportion of private sector jobs. As of 2012, the number of Saudi nationals accounted for 93% of government jobs, while they constituted just 13% of the total workforce in the private sector.

Unemployment is high among youth, who constitute the major proportion of the country’s population. Of the total unemployed Saudis, almost 30% are in the 15–29 age group. Moreover, Saudi youth lack higher education as well as expertise and several nationals are unwilling to accept private jobs at the prevailing wages due to the disparity between average government and private wages.

The country’s unemployment is much higher than that of a few of its regional peers. The average unemployment rate for Bahrain and Kuwait during 2000–12 was 3.7% and 1.5%, respectively, vis-à-vis KSA’s average of 5.5%. Similarly, its unemployment rate is higher than Asian countries such as China, Hong Kong, and Singapore.

The rise in unemployment in KSA, particularly among the youth, poses a major threat to the country’s social stability. To dispel the fear of social unrest due to unemployment, the Saudi Arabian government has taken various steps to improve the country’s unemployment situation such as higher allocation of funds in the budget and royal decrees for education, training, unemployment benefits, and job creation. Two major steps taken by the government are ‘Hafiz’, the Saudi unemployment subsidy program, and Saudization.
Government initiatives to raise employment

The government has implemented a series of measures to boost employment of Saudi nationals, particularly in the private sector.

- Saudization is a policy adopted by the Kingdom to encourage employment of Saudi nationals. It was launched by the government in 2004 in line with the Emiratization program in the UAE (2002), the Omanization program in Oman (1988), and the Qatariization program in Qatar. Under the Saudization program, sectors were required to have a blanket nationalization rate of 30%; just one-third of this has been achieved, even years after implementation. Consequently, the initiative witnessed limited success and the Nitaqat system was launched as an extension to the Saudization program.

- During June 2011, the Ministry of Labor announced the implementation of the Nitaqat system by 2013. Through this system, the country’s private enterprises were categorized and allocated color codes (premium, green, yellow, and red) based on their Saudization rate. Premium and green categories include companies with high Saudization rates, whereas yellow and red include ones with low rates. Companies are provided with incentives or penalties depending on the category they belong to (refer to annexure). Furthermore, according to the law, Saudi workers are counted in the private sector’s Nitaqat percentage only when they receive a minimum monthly salary of SAR3,000. A Saudi worker receiving a monthly salary of less than SAR 3,000 would be counted as ‘half a worker’ and one whose salary is less than SAR 1,500 per month would not be counted in the Nitaqat program at all.

![Figure 1: Nitaqat system – an extension of the Saudization program launched in 2004](image-url)
In 2011, the Ministry of Labor launched the Saudi National Unemployment Assistance Program – Hafiz, another program that provides support to the unemployed and helps them gain employment. Under this program, unemployed Saudi citizens under 35 years receive SAR2,000 a month for up to one year or until they find a job, whichever is earlier. In addition, Hafiz beneficiaries would be provided with online training programs and employment services.

The Saudi government also introduced work visas (Iqama) for the expat population. All private firms would have to pay the government SAR 2,400 per year for every visa renewal for an expat worker. This policy encourages companies to hire Saudi nationals, who are generally more expensive than foreigners.

The new wage monitoring system launched by the government also aims to ensure smooth implementation of Saudization. This system would monitor wage payments by ensuring all KSA and expatriate workers in the private sector are remunerated according to their contracts.

### Challenges in implementing labor laws

**Labor-intensive sectors to be most vulnerable on implementation of Nitaqat**

According to news reports, around 5.3 million foreign workers resigned from their services until September 2013 due to labor laws announced by the government. Although Saudization would help combat unemployment and increase disposable income among Saudi nationals, it would imply higher costs for companies in terms of training locals, higher salaries for locals as compared to expatriates, and loss of productivity. Companies that are highly capital intensive and sectors, such as construction, that employ ~90% non-Saudi nationals would be the most impacted.
Shortcomings of Hafiz program

According to a study by Riyadh Economic Forum, the Hafiz database includes 1.6 million unemployed Saudi nationals, with women alone accounting for 1.2 million. Consequently, 78% of Hafiz beneficiaries are Saudi women. This program has received considerable criticism since a majority of beneficiaries were women and the availability of these benefits could discourage Saudi nationals from considering low-paying jobs in the private sector. According to media reports, several Saudi nationals are taking advantage of the system and have enrolled themselves in the program to receive the monthly allowance.

Levy on expat workers to impact profits of corporates

The increase in visa fees would impact business margins of private firms. A major Saudi construction firm cited this as one of the primary reasons for contraction in earnings. The company expects the government levy on foreign workers to impact its bottom line during the next few quarters.

New labor laws pose challenge for ongoing projects in the country

According to media reports, the value of failing projects in the Kingdom could double to almost SAR 90bn in 2013, given the surge in debt held by contractors, owing to the exit of a large number of construction workers. High debt discourages banks from extending loan to the sector.

Annexure

**Annexure 1: The benefits/penalties that are provided for under each band**

- **Premium-category companies (VIP)**
  - Can recruit foreign workers using easier visa processing
  - Recruit employees from the Red and Yellow category companies and transfer their visas without their employer’s permission
  - Get a one-year grace period when their licenses or registrations expire
  - Transfer the visas of potential employees from other companies, even when the employee has not completed two years with the first employer

- **Green-category companies (excellent compliance)**
  - Apply for new visas once every two months
  - Recruit employees from the Red and Yellow-category companies and transfer their visas without their employer’s permission
  - Change the professions of their foreign employees (except for positions restricted to the Saudi citizens)
  - Get a six-month grace period when their certificates expire
  - Renew work permits of foreign employees, whose visas are valid for three months or more

- **Yellow category companies (poor compliance)**
  - Cannot get new visas, but can get one visa only when two foreign employees depart
  - Cannot transfer visas

- **Red-category companies (non-compliance)**
  - Cannot get new visas
  - Cannot transfer visas
  - Cannot stop Green- or Premium-category companies from transferring their employees' visas
  - Cannot renew employees' work permits
  - Cannot change employees’ professions
  - Cannot open new branches or facilities

Source: News sources
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1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated “Overweight” will typically provide an upside potential of over 10% from the current price levels over next twelve months.

2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated “Underweight” would typically decline by over 10% from the current price levels over next twelve months.

3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated “Neutral” is to stagnate within +/- 10% range from the current price levels over next twelve months.

4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.