The Saudi Arabian Way of Doing Business

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The following article by Rodney Johnson contains a brief outline of how the Saudi oil company, Aramco, came into being. Ray McClain

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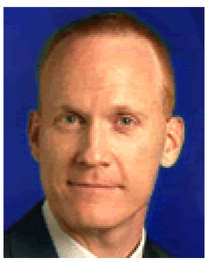
Thanks, Saudis, But No Thanks

By Rodney Johnson, Senior Editor, *Economy & Markets*



Saudi Arabia has a problem. The country's wealth is completely dependent on oil revenue, which state officials use to bribe the population into submission.

But with the price of oil hovering in the mid-$40s, after falling from over $100 in recent years, the Saudis have been dipping into their national piggy bank to make good on their social promises.

They need oil prices over $60 to balance their budget, but that might not be in the cards anytime soon. Looking at a future full of American fracking, country officials decided they needed to change course.

So, they came up with a plan.

To break the country's dependence on oil, it will invest in other technologies and industries, retraining its working population and setting the country on a course for the 21st century.

To finance this transition, the government will sell shares in its national oil company to the public. Most likely, it'll list shares on the national stock exchange and another in a major hub like New York or London.

When shares of the oil company, Aramco, hit the market, it could cause a feeding frenzy.

A word of advice – don't take a bite.

Aramco could be valued between $2 trillion and $3 trillion. The Saudis are talking about selling perhaps 5% of the company, which would raise between $100 billion and $150 billion. For their investment, shareholders would get no control, no visibility, no assurance that company officials would work on their behalf, and a history full of self-interested dealings that are meant to benefit Saudis and no one else.
Thanks, but no thanks.

For those not versed in the history of Middle Eastern oil exploration, ARAMCO stands for Arabian American Oil Company. I won't bore you with all the background details, but a few milestones are noteworthy.

In 1933, Saudi Arabia sold a concession to Standard Oil allowing the company to explore for oil. It took five years, but eventually they found it, and started paying the Saudis a set fee per unit of oil produced.

During the 1940s, other oil companies joined the group, and several major oil fields were found.

Saudi Arabia decided it wasn't getting paid enough after western energy companies started cutting deals with other countries in the area, like Iran. So, in 1950, Saudi officials persuaded Aramco to split the profits 50/50 between the western firms and the Saudi government. By "persuaded," they threatened to nationalize the company's assets. Some deal.

Production continued during the 1950s and 1960s. OPEC formed in 1968 as several oil-producing countries came together after geopolitical tensions bled into their oil operations. By 1973, the Saudi government was again dissatisfied with its profit-sharing. Now, they wanted ownership.

The government again “persuaded” the companies of Aramco to sell 25% to the Saudi government. The share was increased to 60% after the 1973 Israeli Middle East War, and then pushed to 100% by the mid-1970s.

Now, the Saudi government didn’t just take the company. They paid for the shares, which in 1973 terms came to about $2.7 billion. That equates to roughly $15 billion today.

Of course, at the time, the proven oil reserves in Saudi Arabia were just 93 billion. Today they have 260 billion, so Aramco should be worth a lot more.

But how much more? If the company controls three times the amount of reserves, shouldn’t today’s value be three times what they paid, or $45 billion?
Hmmm. Something doesn’t add up.

If the company is worth $2.5 trillion today as Saudi Arabia claims, then it should have been worth a third of that, adjusted lower for inflation, in 1973, given the difference in proven oil reserves. That would put the fair value back then at $155 billion. And yet the Saudis paid just $2.7 billion by threatening nationalization. That’s a heck of a negotiation strategy!

Fast forward to the present, when the country hopes to end its reliance on oil in its national economy. Granted, this will be exceptionally difficult, given that the Saudis produce little other than oil and sand.

But that’s their goal. And to do it, they want to raise money from private investors, who will end up owning part of the very oil company that the government is trying to de-emphasize.

If the Saudis aren’t successful, and oil remains by far the largest contributor to the economy, what happens to shareholders if oil prices are stuck at low levels?

Do they get anything? Dividends? *Anything*? I can't see the Saudis joyfully shipping money out of the country when they are bleeding cash.

And if the Saudis are able to end their reliance on oil, then what? Will they keep investing in new technology and exploration to keep Aramco growing? Or will private investors find themselves holding onto an asset in long-term decline?

Given their history, as well as their goals, this looks like an investment that no one could love.

When it hits the market, expect share prices to move with the price of oil for a little while. But when shareholders find themselves unable to get straight answers from Aramco officials, and then see the kingdom siphon off assets for other projects, chances are these shares will be relegated to an unloved corner of the market.

Rodney