Risk and reward: the Saudi Arabian challenge

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Riyadh has long been, and remains, the power capital of the Middle East. In economic terms it is also the region's 800lb silverback gorilla, and has effectively, if subtly, been asserting this fact with growing confidence in recent years. Despite the ability of neighbouring Doha, Abu Dhabi and Dubai to grab headlines, it is worth remembering that Saudi Arabia's economy is almost 60% larger than the United Arab Emirates and more than three times the size of Qatar. It is also considerably more diversified. An industrial base has emerged, originally clustered around the construction sector and the country's vast hydrocarbons resources, including downstream derivatives such as petrochemicals, but increasingly with an emerging manufacturing base. There is also a fast-growing consumer sector which had driven demand for imports as well as the development of the local economy.

The Saudi Government remains committed to sustaining fast-tracked growth and is aware that there is no alternative. Demographics alone provide a compelling reason: with a population of 29 million people, some 40% of which are under the age of 17, the Government is acutely aware of the looming social and political challenges posed by unemployment, made all the more pressing by political upheaval elsewhere in the Middle East and North Africa.

The response has two core components, both of which are tried and tested. First, the philosophical debate over private versus public sector was resolved long ago: the Government has embraced the reality that a dynamic private sector will create jobs, wealth and opportunity, and the last decade has seen a series of policy initiatives aimed at deregulation and opening markets. Much of the structural reform has focused on attracting foreign direct investment, with a Saudi twist: unlike other markets, it is less the capital that is required - there is no shortage of that domestically - but rather technology, management and marketing capacity.

Second, the Government has made an aggressive commitment to primary stimulation: its own investment agenda is huge. The Ministries of Housing, Interior, Defence, Health, Telecommunications, Industry, Oil, and Social Affairs are currently driving ambitious spending programmes for infrastructure development across all sectors of the economy. Despite the global economic downturn from which many countries in the Gulf have yet to recover, Saudi Arabia's infrastructure expenditure - with US$184 billion budgeted in 2012 - continues to provide meaningful momentum, and a host of opportunities for domestic, regional and international private sector players.

Unsurprisingly, improved accessibility and expanding opportunity have attracted a fresh wave of interest from

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UK companies. However, participants need caution: regardless of whether wholly-owned operations are established or joint ventures formed with local businesses, as with many markets there comes an increased potential for fraud and corruption. The ingredients are there on the table: cross-border joint ventures with unfamiliar partners; limited transparency; Government-led development programmes and a broad interface between the public and private sectors; technologically complex, large-scale, and intertwined projects with unwieldy international consortia; and an unfamiliar legal environment to navigate.

In Saudi Arabia, reputational, integrity, regulatory, operational and commercial risks are intertwined. As a result, the need for robust due diligence is heightened, and this in an environment in which the gathering of reliable information can be challenging. The public domain is narrow and incomplete, and there can be a surplus of incoherent, or incomprehensible, reputational "noise". The harvesting and analysis of business intelligence can be a complicated process for those inexperienced in the Kingdom, but will provide the solid foundations upon which joint ventures, or relationships with counterparties, must be built.

Perhaps most important is the provision of context. In recent years, Saudi Arabia has introduced robust measures to enhance its drive to fight corruption. The first move was publication of the National Strategy for Maintaining Integrity and Combating Corruption, adopted in 2007, which provided the blueprint for fighting corruption. Perhaps the boldest move was the decision by the King to establish the National Anti-Corruption Commission in 2011. This Commission has direct oversight of all Government bodies and corporate entities in which the Government holds a 25% or greater equity stake. The Commission is tasked with raising awareness of corruption, investigating and combating it, and ensuring the return of embezzled funds. The body's creation was prompted, at least in part, by a number of recent high-profile debacles in the Kingdom, including the Al Gosaibi-Ma'an Al Sanea dispute and the Jeddah flooding. The Government's investigation into the latter led to a Saudi public official and businessman being jailed for five years and fined for receiving and paying bribes.

A number of other bodies are also responsible for fighting corruption in the country, including the Prosecution and Investigation Commission, the General Auditing Bureau, and the Auditing and Investigation Commission. The legal basis for these initiatives is embodied in a series of decrees and laws passed by the King and ratified by the Council of Ministers. Although Saudi laws generally deal with the behaviour of public officials rather private commercial bribery, the Government has made good progress towards regulating the public

sector and laying the platform for a stringent compliance environment. Many Saudi businesses, however, are lagging behind and have yet to develop mature internal compliance mechanisms and procedures. This is more than a question of insufficient compliance processes of domestic operations: the rapidly accelerating globalisation of Saudi enterprise, while an economic success story, is also a multiplier of risks.

In the most recent Kroll Global Fraud Survey, 56% of respondents in Saudi Arabia said that their companies did not suffer from any type of fraud in the past year. From what Kroll has seen on the ground, there is clearly a wide gap between the perception of threat and the actual risk that Saudi businesses are facing in both domestic and foreign markets.

This severe under-estimation of the prevalence of fraud is particularly worrying: there is no more effective way to invite attack than to lower defences. In our experience, the wider this gap grows, the greater the real risk becomes, and the greater the need for anti-corruption programmes and training. It is also our experience that, predictably, those who have been impacted by fraud are the fastest learners, and those that have not are more inclined to sweep the problem under the carpet until they have. Put simply, there are specific risks faced by foreign investors in Saudi Arabia, whether they are partnering with local businesses or entering the market alone and forming direct commercial relationships. The most effective approach is to complete rigorous investigative due diligence on potential partners and counterparties before entering into the relationship. Prevention is better - and cheaper - than cure.

Companies need to develop a deep understanding of counterparties, and to conduct a risk assessment of the transactions and the key principals surrounding them. Although fraud comes from multiple directions and sources, the main ones we have seen in Saudi Arabia involve management conflict of interest, theft of physical assets, regulatory breaches, and bribery. The good news is that 62% of Saudi businesses participating in the Kroll survey now have some form of pre-deal due diligence in place. More interesting is that 88% of respondents indicated that they have a well-defined whistleblower process, which perhaps reflects that Saudi businesses are now beefing up their corporate governance structures.

Based on these figures and our experience in the market, it would appear that systematic methods toward risk management and mitigation have been adopted by some of the leading Saudi corporations and private offices; others lag. Our experience also shows that UK companies entering the Kingdom are now engaging external specialists and risk consultants to conduct investigative integrity and reputational due diligence before they enter into new relationships, as well as fraud-related reviews and the design and implementation of fraud prevention programmes within their established ventures in the Kingdom. However, they remain in the minority and many still make the mistake of assuming that lawyers and accountants alone can provide sufficient protection. This suggests there is some pain to come, and the consequences could prove far-reaching and have considerable financial repercussions. ■

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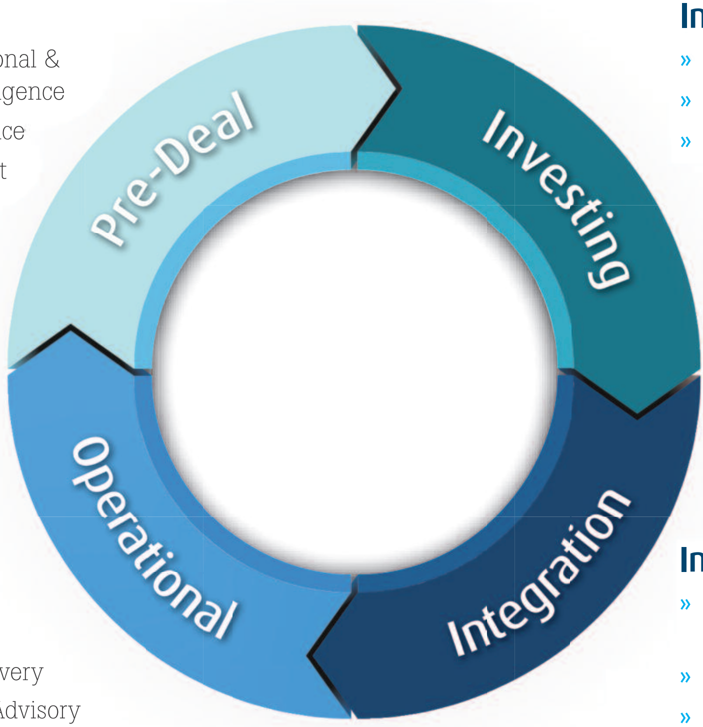

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