

Saudi Arabia Could be Emerging Markets' Next Rising Star

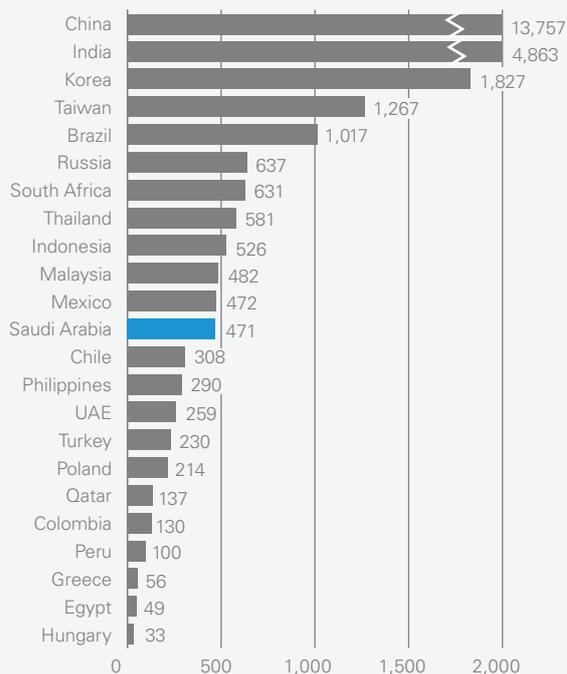
Walid Mourad, Senior Vice President, Portfolio Manager/Analyst

Saudi Arabia has been making a push to attract foreign investors by opening up its capital markets as the kingdom attempts to diversify the economy and reduce its dependence on oil revenue. Foreign ownership has languished, however, as investors have focused on the government's austerity push and recent domestic political changes rather than market reforms. Announcements from MSCI and FTSE Russell suggest the country could be promoted to emerging markets status this year, something that will likely draw global investors' interest and serve to highlight the opportunity in this deep, diversified market that has been overlooked by many global investors until now.

The Saudi Equity Market

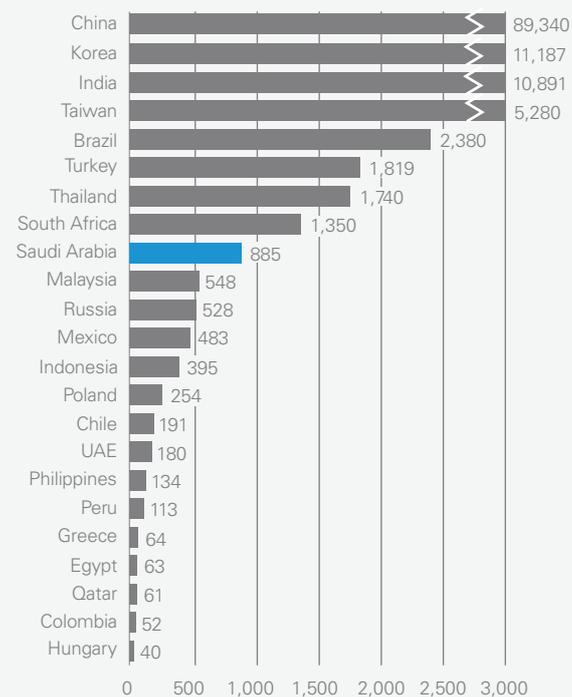
The Tadawul—the Saudi Arabian Stock Exchange—is already a titan among regional peers, but the size and liquidity of its market also rivals that of some emerging economies. Not only is Saudi Arabia by far the deepest market in the Middle East, it is also more liquid than Russia's market and almost as liquid as Turkey's. Saudi Arabia's significance among local peers is well understood, but its potential importance in an emerging markets context is often overlooked (Exhibits 1 and 2).

Exhibit 1
Saudi Arabia's Market Size Stacks up well against EM Peers



As at 31 December 2017
Countries ranked by market capitalisation (US\$ bn).
Source: Bloomberg

Exhibit 2
Saudi Arabia is the Ninth-Most Liquid Market in EM



As at 31 December 2017
Countries ranked by six-month average daily trading volume (US\$ mn).
Source: Bloomberg

Saudi Arabia's Tadawul Index is not only the region's largest equities market, but it is also one of the most diverse, consisting of close to 180 stocks across a range of sectors. While financials and materials combine to comprise over half the market, listed companies span a variety of sectors, such as telecom services and real estate, making it more representative of the real economy compared to regional peers (Exhibit 3).

While Saudi Arabia constitutes more than 50% of the S&P Pan Arab Composite LargeMidCap Index with an average daily liquidity of US\$885 million, sell-side coverage remains low and is limited to approximately 55% of listed entities (Exhibit 4).

The key reasons for the lack of coverage are as follows:

- Strong institutional interest in a market tends to attract more sell-side interest. However, Saudi Arabia's stock market is retail investor dominated, constituting over 70% of daily trading activity
- Management accessibility has historically been poor, although things are improving as most companies are starting to invest in investor relations personnel
- Financial reporting had previously lacked consistency, although regional markets in the Middle East have now largely adopted International Financial Reporting Standards
- Foreign ownership (excluding strategic investments) remains low at approximately 1.5% of the total market capitalisation of Saudi Arabia's Tadawul Index, as most institutional investors cannot invest directly in the market, and are limited to using synthetic instruments, such as Participatory Notes and Total Return Swaps, as licensed by a select number of brokers.

Exhibit 4
Analyst Coverage of Saudi-Listed Stocks Remains Low

	Listed Companies	Sell-Side Brokers	Coverage (%)
Consumer Discretionary	24	10	41.7
Consumer Staples	16	8	50.0
Energy	4	3	75.0
Financials	49	24	49.0
Healthcare	7	6	85.7
Industrials	21	10	47.6
Information Technology	1	0	0.0
Materials	41	33	80.5
Real Estate	11	6	54.5
Telecom Services	4	3	75.0
Utilities	2	1	50.0

As at 31 December 2017

Source: Arqam Capital, LGL Research

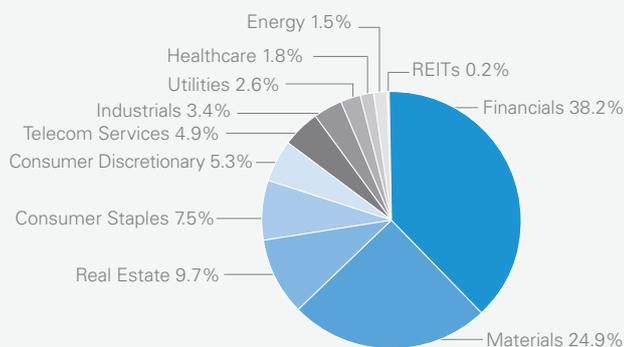
Saudi Arabia's Push for Inclusion

Saudi Arabia has been pushing ahead with capital market reform measures for over two years. Saudi Arabia opened its equity markets to foreign direct investments in June 2015 through a Qualified Foreign Investor (QFI) programme. It has eased access further by:

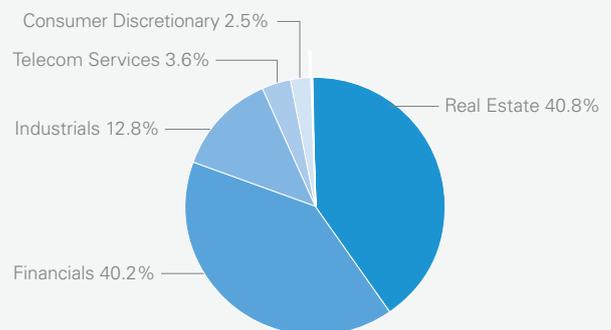
- Reducing the minimum assets under management for QFIs to US\$500 million from US\$1 billion
- Adding new types of eligible QFIs, such as sovereign wealth funds and university endowments.

Exhibit 3
Saudi Index Outshines Regional Peers in Sector Diversity

Composition of Saudi Arabia's Tadawul Index



Composition of the Dubai Financial Market General Index



As at 30 September 2017

Source: Dubai Financial Market General Index, Tadawul

Foreign ownership limits have also been raised from 20% to 49% since September 2016 in a bid to attract more foreign investors. To further align Saudi Arabia's capital markets with international standards and to increase transparency and liquidity, the country transitioned to a T+2 settlement cycle, from T+0, for all listed securities and also introduced securities borrowing and lending and covered short selling.

In recognition of Saudi Arabia's capital market reforms and continued enhancements, MSCI announced it would consider the MSCI Saudi Arabia Index for inclusion in the MSCI Emerging Markets Index, and is expected to communicate its decision in June 2018. This follows in the steps of FTSE Russell, which added Saudi Arabia to its watch list for potential reclassification to secondary emerging markets status in September 2015. Expectations that Saudi Arabia will meet requirements for inclusion were given fresh impetus by FTSE Russell's launch of the FTSE Saudi Arabia Inclusion Index Series in October 2017, designed to enhance market access and serve as a transitional tool in preparation for Saudi Arabia's potential inclusion in the widely followed FTSE Global Equity Index Series.

Historically, Saudi Arabia's government has relied heavily on oil as a main source of revenue, which accounts for nearly 70% of the country's budget revenues¹. At the heart of Saudi Arabia's efforts is the country's National Transformation Plan (NTP), devised in response to the collapse in crude oil prices and the resulting budget deficit that has persisted since 2013. The NTP sets out a series of reforms ranging from female participation in the workplace to tackling government bureaucracy in a bid to revamp the economy. The overarching ambition, however, is to reorient the economy and break its long-held dependence on hydrocarbon revenues.

One of the key pillars of the Saudi Arabian government's plan is the privatisation of state assets, the proceeds of which it would use to fund non-oil investments. For instance, the government is set to partially privatise Aramco—Saudi Arabia's national oil company—this year, in what could be the world's biggest initial public offering. A dual listing in Riyadh and an international stock exchange is currently expected.

Additional listings of government assets are likely given the establishment of multiple supervisory committees, set up to work alongside other government agencies to coordinate the privatisation programme. The Saudi Arabian government has so far suggested that more than 16 government entities are primed for listing.

The high concentration of domestic ownership of Saudi Arabian equities—which stands at approximately 70%—heightens concerns around liquidity and raises the potential for periods of marked volatility—factors that would deter foreign investors and hinder the potential scale of the market through reduced flows.

Index funds and exchange-traded funds collectively have trillions of US dollars benchmarked against the MSCI Emerging Markets Index. Saudi Arabia's potential inclusion in international indices would allow the country to tap into a wider pool of international investors, gain scale, and deepen its capital markets and influence on the global stage.

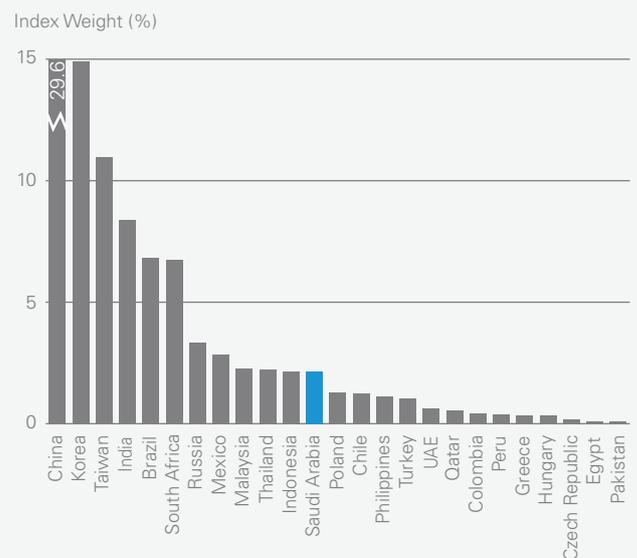
The pace at which Saudi Arabia has been carrying out capital market reforms is, in our view, commendable. It is also worth noting that Saudi Arabia recently moved to tap international bond markets for the first time in a bid to tackle its fiscal challenges through debt issuance, in parallel with other measures. Saudi Arabia is in a strong position to do so, given its debt-to-GDP of around 12%, which is well below the average for the region and emerging markets more broadly.

What Potential Inclusion Could Mean for Saudi Arabia

MSCI has calculated that upon potential inclusion in the MSCI Emerging Markets Index, Saudi Arabia would have a weight of 2.1%, placing it among the top 12 countries in the index (Exhibit 5). In the MSCI Emerging Markets EMEA Index, Saudi Arabia's weight could place it in the top three (Exhibit 6).

According to MSCI, around US\$1.5 trillion of investment funds track the MSCI Emerging Markets Index globally. Based on a weighting of 2.1%, we would expect to see passive inflows of around US\$32 billion for Saudi Arabia, albeit not instantaneously.

Exhibit 5
Saudi Arabia Could Be Among the 12-Largest EM Countries

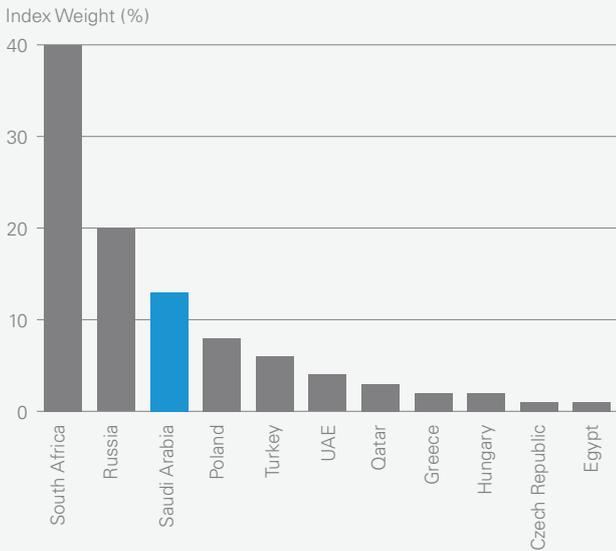


As at 31 December 2017

Estimates based on Saudi Arabia's potential inclusion in the MSCI Emerging Markets Index. Countries ranked by market capitalisation.

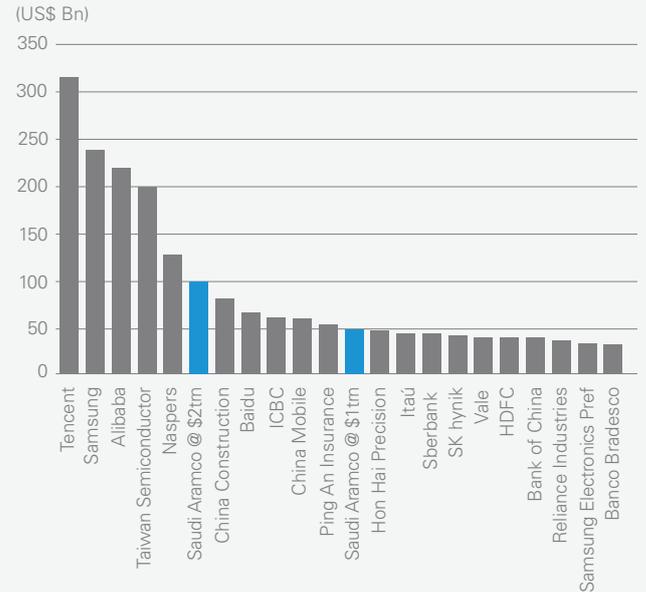
Source: Arqam Capital, MSCI

Exhibit 6
Saudi Arabia Could Be the Third-Largest Market in Emerging EMEA



As at 31 December 2017
 Estimates based on Saudi Arabia's potential inclusion in the MSCI Emerging Markets EMEA Index. Countries ranked by market capitalisation.
 Source: Arqam Capital, MSCI

Exhibit 7
Aramco Could be a Top Constituent in the EM Index



As at 31 December 2017
 Companies ranked by market capitalisation.
 Source: Arqam Capital, LGL Research.

Saudi Aramco Could Substantially Boost Saudi Arabia's Market Cap

Saudi Arabia's government is looking to partially privatise Saudi Aramco—the country's state-owned upstream oil and gas major—later this year. The company is expected to list a minimum of 5% of its shares in a dual listing. While a formal timeline has not been announced, Saudi Arabia's government has said it wants the sale to take place before the end of 2018. In the second quarter of 2017, the government reduced the company's tax rate—a key component in determining the valuation and dividend policy for Aramco—from 85% to 50%.

Valuations for Saudi Aramco have been wide ranging, but Saudi officials have suggested the company could be worth up to US\$2 trillion. This could potentially boost Saudi Arabia's weighting in the MSCI Emerging Markets Index close to 5% and would suggest an additional US\$5 billion to US\$10 billion in passive inflows. Post-listing, Saudi Aramco has the potential to be among the 20 largest companies by market capitalisation in the MSCI Emerging Markets Index, even when based on conservative valuation estimates (Exhibit 7).

Conclusion

Saudi Arabia's capital market reforms have been progressive, culminating in the country being considered for emerging markets status. Noteworthy reforms over the last two years have included further enhancements to existing measures, and operational and regulatory improvements at the Saudi Stock Exchange.

Saudi Arabia's growing importance, potentially in an emerging markets and even global context, would undoubtedly help the country diversify its investor base and capital sources, and open its market to large institutional foreign investors, investment from which has so far been relatively restricted.

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Notes

1 Kingdom of Saudi Arabia, 2017 Budget

Important Information

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