جدوى للإستثمار
Jadwa Investment

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Update: Opening the Tawadul up to Foreign Investors

Overview

Last week the Capital Markets Authority (CMA) confirmed that the region's largest, diverse and most mature capital market, the Tadawul, will be open to qualified foreign institutional investors (QFIs). In April 2015 the Saudi stock market's capitalization stood at $528bn, equivalent to two thirds of Saudi GDP, making it larger than the Mexican stock market. When compared regionally it is almost the same size as all the other equity markets in the Gulf combined. Opening up the market is likely to lead to inclusion into the MSCI emerging market index by mid-2017, with as much as $40-50 billion of total foreign inflows.

Since the publication of our original report back in August 2014, *Opening the Tawadul up to Foreign Investors*, we have seen a number of developments which have impacted the Tadawul All Share Index (TASI). This includes a massive drop in oil prices which negatively impacted investor sentimental and led to panic selling, and the $6 billion initial public offering (IPO) of the National Commercial Bank (NCB), which amounted to the second-biggest IPO of 2014 globally. Below we discuss some recent developments in more detail.

CMA draft proposals

Back in August 2014 the CMA set out draft rules for the participation of investors in the Tadawul. Included in these draft rules are the limitations for QFI participation in the Saudi stock market. These are outlined below:

- QFIs wanting to participate in the Saudi stock exchange will have to have at least USD5 billion assets under management (AUM) (possibly reduced to USD3 billion) and have been operational for a minimum of 5 years.
- Each QFI (including affiliates) can only hold a maximum of 5 percent of issued shares of any one listed company.
- All foreign investors (including resident and non-resident, swaps and QFIs) have a combined ceiling of 49 percent ownership of issued shares, in any one listed company.
- QFIs together can only own a maximum of 20 percent of issued shares of any one listed company.
- Swaps and QFIs can only own up to a maximum of 10 percent of aggregate stock market value of all listed companies.

The CMA has confirmed that the opening of the stock market is to support the increased participation of institutional investors and reduce the role of retail investors. The draft proposals have obviously been carefully considered to reflect this goal. After consultation with various relevant parties, the full rules for participation will be published on 4th May. We believe that one of the results of the consultation will mean that definition of QFIs and QFI Clients will

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include Sovereign Funds, Public and Private Pension Funds or Endowments, Foundations and sophisticated family offices. We view the inclusion of such entities as an overall positive, since they are major investors in the global marketplace and stable in the nature of their investment patterns.

We believe it is worth further clarifying certain provisions to eliminate unintended ambiguity and potential misinterpretation.

Furthermore, we believe it is also worth clarifying certain provisions in the draft proposals so to eliminate any unintended ambiguity and potential misunderstanding. In particular, we believe that the role of authorized person's (AP) relationship with QFIs has not been fully detailed. In specific, some clarification over whether APs are likely to be able to manage QFI clients fund would be welcome. Also, banks, brokerage and securities firms are included as institutions that could be permitted to participate as QFIs in the Saudi stock exchange, but, at the same time, the limit set for QFIs for assets under management (AUMs) is at USD5 billion (SR18.75 billion). Since many banks, brokerage and securities' firms do not participate in asset management, this could limit their inclusion. Lastly, we believe an elaboration on the exact nature and timing over the proposal to gradually reduce the AUMs requirement from USD5 billion (SR18.75 billion) to USD3 (SR11.25 billion) would be beneficial to both local and QFI participants.

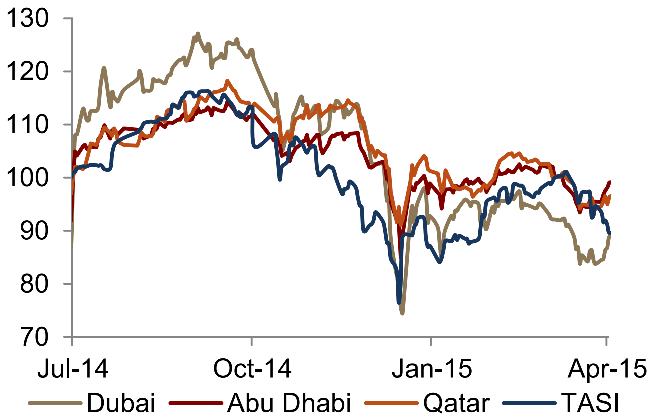
Recent TASI performance

The steep decline in oil prices has negatively impacted all GCC indices.

The TASI's losses are not reflective of market fundamentals.

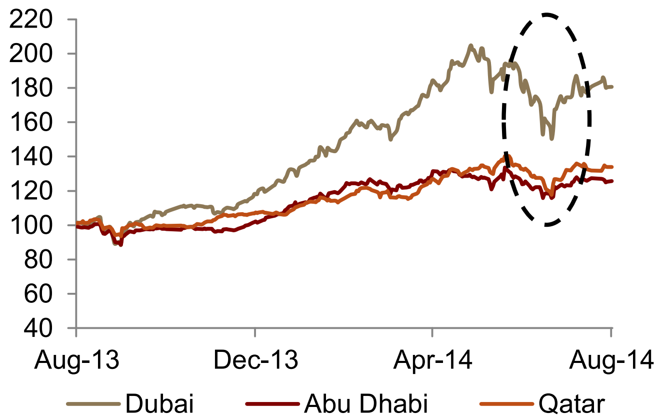
The steep decline in oil prices, by around 50 percent since mid-2014, has negatively impacted oil exporting countries with all GCC countries indices being down in the last six months to April 2015 (Figure 1). In the case of the TASI the losses were not reflective of market fundamentals but caused by panic selling. As oil prices tumbled, many retail investors feared that lower oil prices would prompt the Saudi government to slow, or even worse, cut back on expenditure, which would squeeze corporate profits. The fall in TASI was further exacerbated by investors selling off securities in order to free up cash to deleverage from margin calls, as collateral values declined. Investors' fears over lower fiscal and business related spending were allayed when the Saudi government pushed through another expansionary fiscal policy at the end of 2014. Since then, the TASI's recovery has been helped by a smooth Royal succession, two salary bonuses to public sector employees, and a stabilization in global oil prices.

Figure 1: GCC stock markets down*



*Note: rebased to 100 at July 2014

Figure 2: Qatar & UAE Markets & MSCI Inclusion



*Note: Rebased to 100 at August 2013

The IPO pipeline for 2015 is likely to be attractive, including a mix of companies from different sectors.

Looking ahead, despite the lower priced oil market (we see full year Brent averaging $61 per barrel for 2015), Saudi Arabia's huge foreign reserve ($710 billion at the end of February 2015), and low debt-to-GDP levels (1.6 percent of GDP-allowing ample room to issue sovereign debt), all means that the government can remain committed to key large-scale industrial projects and an economic diversification strategy. We see this diversification strategy not only driving private sector activity, which will support the performance of listed companies, but also support strong IPO activity as the private sector is handed a larger role in being the main driver of growth going forward. In 2014, we saw the $6 billion IPO of the NCB, and the IPO pipeline for 2015 is likely to be just as attractive, including a mix of companies from different sectors, including transport, manufacturing, health care, and retail. Furthermore, if you consider that some sectors benefit from subsidies, through capped energy prices or low-priced feedstock, and foreigner's investing in the Saudi stock market reap the benefits of a zero tax liability on capital gains, plus the withholding tax rate of 5 percent on dividend payments is amongst the lowest globally, it becomes apparent that the Saudi stock market is very attractive for QFIs.

Fairer valuations

The recent decline in the TASI has seen valuations cool…

...but risks in over pricing still exist.

Although the recent decline in the TASI has led to valuations cooling in the Tadawul, risks still remain in overpricing prior to accepting foreign investors directly. When the Saudi stock exchange opens to foreign investors by mid-2015, a similar pattern of events occurring to what we saw in Qatar and the UAE is still likely. Stock markets of both Qatar and the UAE rose before the inclusion of the respective indices, in early June 2014, into the MSCI Emerging Markets Index, and then dipped immediately after. Qatar's benchmark QE Index advanced to five year highs in early June 2014 and then dropped, whilst shares on the Dubai Financial Market General Index dropped by 22 percent by the end of June 2014 (Figure 2).

Immediately after the announcement by the council of ministers back in July 2014, the Saudi bourse was moving towards being over-heated. The TASI rose by 14 percent in less than two months to a 7 year high of 11,149 points in September, and price/earnings (PE) valuations were trending above the long-term average. Since the

Figure 3: TASI price earnings

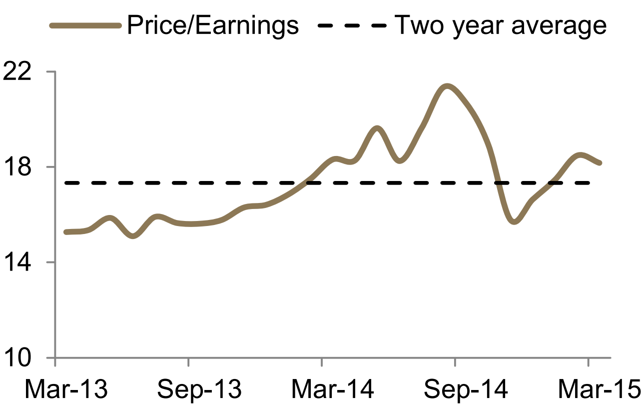
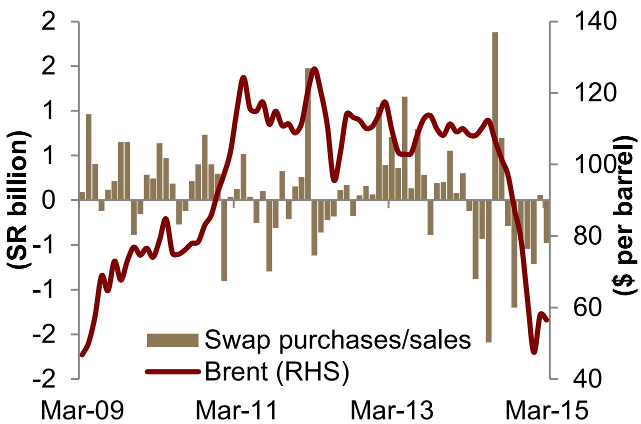


Figure 4: Oil prices and SWAPs



beginning of October the TASI has declined by 17 percent, although the declines were steep and ultimately contributed to the cooling of valuations, we are now seeing an upward trend in PE valuations building momentum again (Figure 3).

Oil prices, geopolitics and foreign investors

Oil prices and regional geopolitical developments, have tended to affect foreign investor sentiment.

Investors provided ample evidence to differentiate Saudi Arabia's outlook from other troubled regional economies.

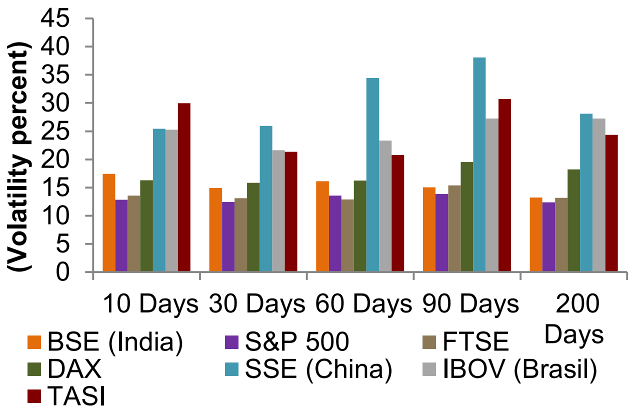
In the last five years regional geopolitical developments, and their impact on oil prices, have affected foreign investor sentiment more sharply. Looking at historical trends we see that in times of either regional instability, during 2011, or sharp oil price declines, in April 2010, March 2012, second half of 2014 and early 2015, there has been a net sell-off in Swap arrangements. But when both the price of oil and geopolitical developments have stabilized, November 2009 to November 2010, November 2012 to January 2014, Swap arrangement purchases have increased (Figure 4). This shows that, despite short-term sentimental reactions to oil prices and regional tensions, foreign investors will continue investing in the Kingdom, over the longer term. This is due to the centrality of Saudi Arabia to global energy markets, and the global economy. Indeed, global investors have been provided with ample evidence, through continued stability and sustained economic growth, to be able to differentiate Saudi Arabia's outlook from other troubled regional economies. Indeed, Saudi Arabia's willingness and ability to honor its spending commitments, through massive foreign reserves and debt issuance, in order to deliver economic growth, has become apparent.

Volatility

The Saudi stock exchange's trading activity is dominated by local retail investors.

The Saudi stock exchange's trading activity is dominated by local retail investors. According to the CMA, at the end of 2014 around 2.4 million retail investors had invested in listed companies, holding just over a third of total listed Tadawul shares by value. Currently, retail investors in Saudi Arabia account for a higher proportion of traded volumes, at 90 percent, when compared to other large market indices. In India, retail trade volumes account for around 34 percent, with retail investor volumes much smaller in the U.S, where they account for less than 2 percent.

Figure 5: Comparable stock market volatility



Volatility is measured by standard deviation which shows how widely an investment's returns varies from the investment's average return over a certain period (i.e. between10 to 200-days)

As a result, the TASI exhibits higher levels of volatility over a shorter time period.

Retail investors, in general, tend to have larger risk appetites and shorter investment horizons compared to their institutional counterparts. As a result, the TASI exhibits higher levels of volatility over a shorter time period. For example, 10-trading day volatility at 2.3 times the volatility of the S&P 500 Index and 1.7 times the volatility of the Bombay Stock Exchange (BSE). Over a longer period volatility in TASI falls in line with major emerging market indices (Figure 5). The CMA's draft proposals have only approved institutional investors and not individual investors. Institutional investors, in general, play an important role in developing financial markets since they act as conduit to channel individual savings into capital markets through longer term investment horizons. The opening up of the Saudi stock market, we believe, is therefore an initial step in the longer term objective of gradually moving towards more developed stock markets, where institutional investors are more prevalent over their retail counterparts.

Transparency

The process of opening up the stock market should also be accompanied by increased transparency from administrative bodies.

The process of opening up the stock market should also be accompanied by increased transparency from administrative bodies, through the availability of consistent macro-level information. Countries that have some of the most sophisticated and advanced stock markets also have a body of pre-defined periodic statistical publications made available by public bodies. In specific, the availability of timely and consistent macro-level data, such as economic and demographic statistics, contribute to private information gathering and dissemination, all of which, in turn, contributes to developing well-functioning stock markets. Specifically, we see the lack of consistent macro-level economic information partly leading to a disconnect between the performance of the Saudi stock market and macro-economic fundamentals of the Kingdom. Therefore looking ahead into 2015, although we see the TASI improving, the increase in prices and values of stocks will not necessarily reflect the Kingdom's strong macro fundamentals, but perhaps will be reflective of short sharp movements dictated by oil prices, regional geopolitical developments and international economic performance. In the long-haul we expect to see more of a connect between the Saudi stock market and the domestic economy.

China's slow but steady approach

The CMA draft rules on opening up to foreign investors are in line with other stock market openings…

...but China's approach, in particular, offers a good example.

The CMA draft rules on opening up to foreign investors are in line with stock market openings of other countries, but China's approach, in particular, offers a good example. Similar to levels in the TASI, retail investors in the SSE account for 80 percent of stock market volume, but only own around a quarter of total market capitalization. Although the Chinese Securities Regulatory Commission (CSRC) has been trying to take steps to move the SSE in line with international equity markets, it has done so in a cautious manner. The SSE has been accepting qualified foreign investors (QFIs) since 2003 but at the end of 2013 the total value of stocks held by foreign investors accounted for only about 1.6 percent of total market capitalization. Although a push by the China Securities Regulatory Commission (CSRC) will see this increase to 4 percent by 2016, it still represents a gradual and cautious opening.

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