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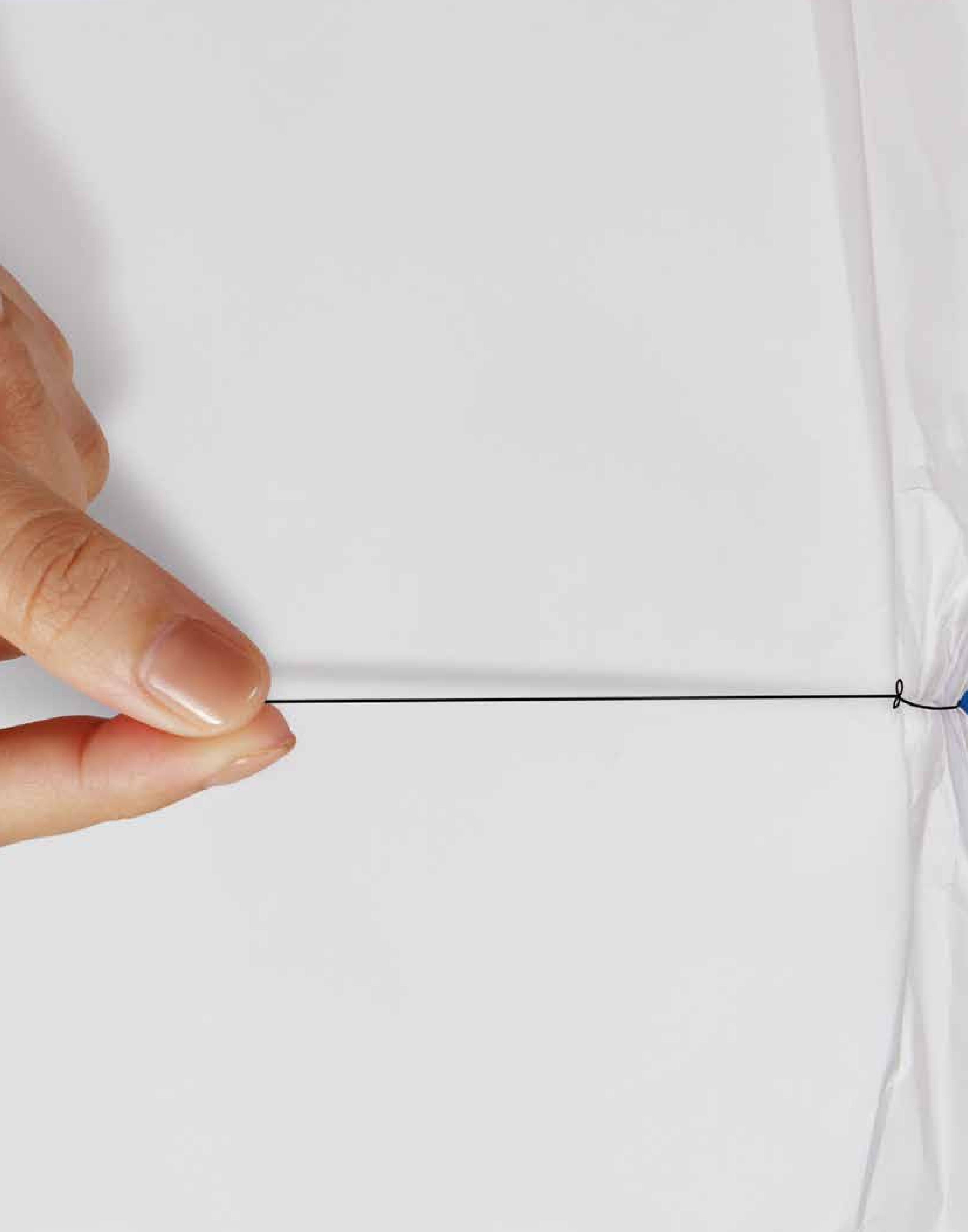
Market Liberalization in Saudi Arabia:

Opportunities Galore for Foreign Investors

2014



Report Prepared by: Prahlad Bhanushali, Rishiraj Agrawal, Ati Ranjan

Contents

1

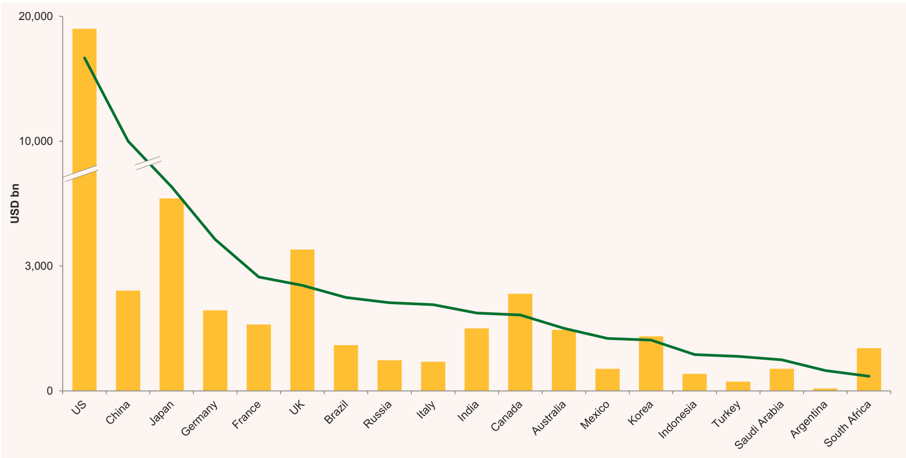
Multi-billion dollar investment opportunity in KSA

In July 2014, authorities approved plans to fully open the Saudi stock exchange (Tadawul) to foreign direct investments (expected by 1H 2015). The move is believed to be a precursor to the much-coveted inclusion of Tadawul in the MSCI EM Index (likely to take place in 2017). Following the recent upgrade of the UAE and Qatar to emerging-market status, this could enhance MENA's visibility among global investors, increasing its weightage to 5.35% (including Saudi Arabia's 4%) vis-à-vis 1.35% currently. Given the scenario, global portfolio managers are expected to allocate around USD40bn to Saudi Arabia. In addition to passive investment, we expect a lot of active money to begin flowing into the Kingdom, given the fundamental strength of KSA's economy and stock market.

Saudi Arabia, the last G-20 country to open doors to foreign investors

Saudi Arabia, the largest country in MENA by market capitalization and GDP, is the last of the G-20 countries to open its stock market to full foreign participation. Except China, where there is a cap on investments for Qualified Foreign Institutional Investor (QFII), all other G-20 markets are fully open to foreign direct investments. Saudi Arabia's market cap to GDP ratio currently stands at 0.71, lower than the G-20 average of 0.79 and significantly below that of the US (1.14), Japan (0.94), the UK (1.34), Canada (1.28), Australia (0.97), South Korea (1.07) and South Africa (2.93). We believe opening doors to foreign investors would bring the ratio closer to 1; our back of the envelope calculation indicates that deepening of the market would mean more than USD150bn addition to market capitalization if the MCap/GDP ratio improves by just 10 basis points.

Figure 1: MCap to GDP ratio of just few G-20 countries greater than 1



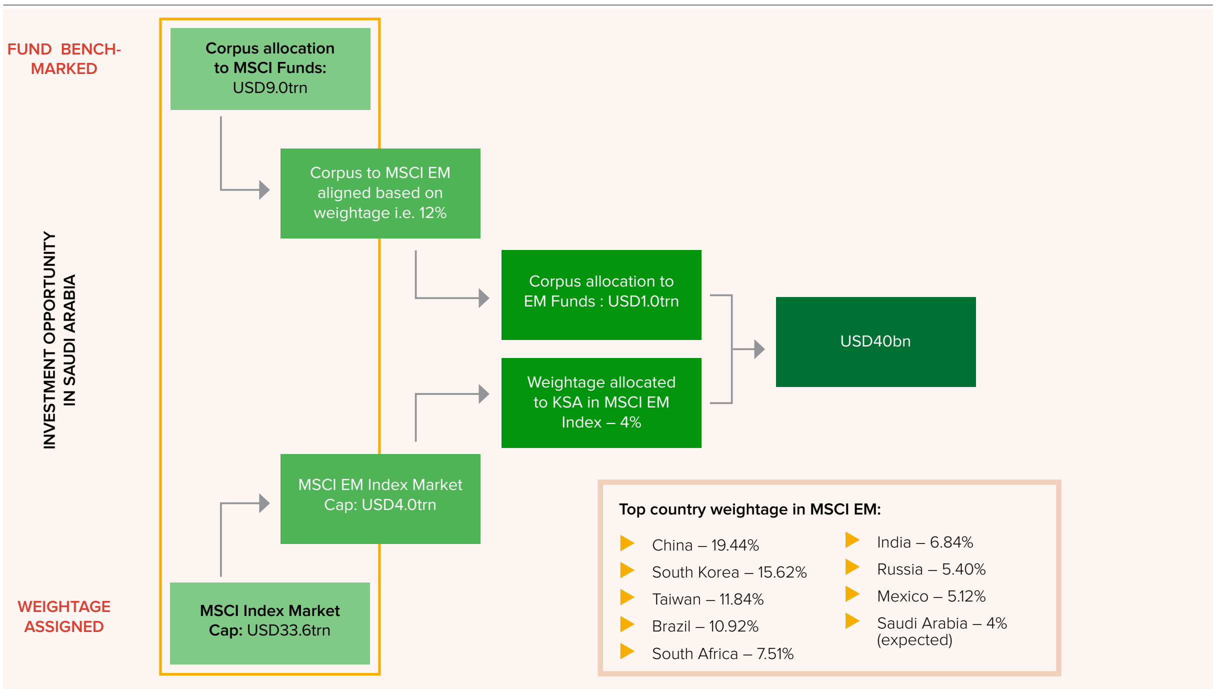
Source: World Exchanges, IMF World Economic Outlook Database, April 2014

Inclusion in MSCI EM Index to attract significant inflows

Based on our preliminary calculations using funds benchmarked to the MSCI EM Index and weightage based on market cap, we expect global portfolio managers to eventually allocate about USD40bn to Saudi Arabia. According to the July 2014 MSCI EM factsheet, funds aligned to MSCI indices totaled USD9trn. Considering the market cap approach to calculate weightage, the MSCI EM has 12% weightage on MSCI; this translates to an allocation of USD1trn. The MSCI Saudi Arabia Domestic Index has a free float market cap of USD194bn from 45 constituents. Based on our calculation, this indicates roughly 4.7% weightage on the EM Index; however, going by the market's estimate, even if weightage is around 4%, it represent a potential investment of around USD40bn.

Once included, Saudi Arabia would be among the top ten countries in the MSCI EM list of 23 nations, which is currently dominated by China (19.44%), South Korea (15.62%), Taiwan (11.84%), Brazil (10.92%) and South Africa (7.51%).

Figure 2: Expected structure of MSCI EM after inclusion of Saudi Arabia



Source: MSCI, Aranca research

Rapid strides toward inclusion in MSCI EM; likely by 2017

The three major criteria to enlist in the EM Index are economic development; having the requisite size and liquidity; and market accessibility. Saudi Arabia is currently at par with developed markets with regard to the first two parameters. However, it lags in terms of market accessibility, particularly openness to foreign ownership and efficiency of operational framework. In line with the aim to fully liberalize the Saudi market by 1H 2015 and bring it at par with international standards, authorities in KSA are taking steps aimed at effective governance of market and building a trading technology framework, among others. Therefore, we believe Saudi Arabia would be a part of the MSCI EM Index in 2-3 years, taking much lesser time than the UAE and Qatar (5–6 years).

Figure 3: Saudi Arabia standing on par with the developed markets requirements on several parameters

CRITERIA	FRONTIER	EMERGING	DEVELOPED	SAUDI ARABIA
A. Economic development				
Sustainability of Economic development	No requirement	No requirement	GNI per Capita 25% > above World Bank High Income threshold	DEVELOPED
B. Size and Liquidity Requirements				
No of companies meeting the below criteria:-	2	3	5	DEVELOPED
Company size	USD 449 mn	USD 898 mn	USD 1796 mn	DEVELOPED
Security size	USD 33 mn	USD 449 mn	USD 898 mn	DEVELOPED
Security Liquidity	2.5% ATVR	15% ATVR	20% ATVR	DEVELOPED
C. Market Accessibility Criteria				
Openness to foreign ownership	At least some	Significant	Very high	FRONTIER
Ease of capital inflows/outflows	At least partial	Significant	Very high	DEVELOPED
Efficiency of operational framework	Modest	Good and tested	Very high	FRONTIER
Stability of institutional framework	Modest	Modest	Very high	EMERGING

Opening up of the market illustrates its commitment to attract foreign investors

2008: UAE and Qatar first sought for inclusion in MSCI EM
2013: Announced approval
2014: Finally included

Source: MSCI, Aranca research

2

Importance of Saudi Arabia as an investment destination

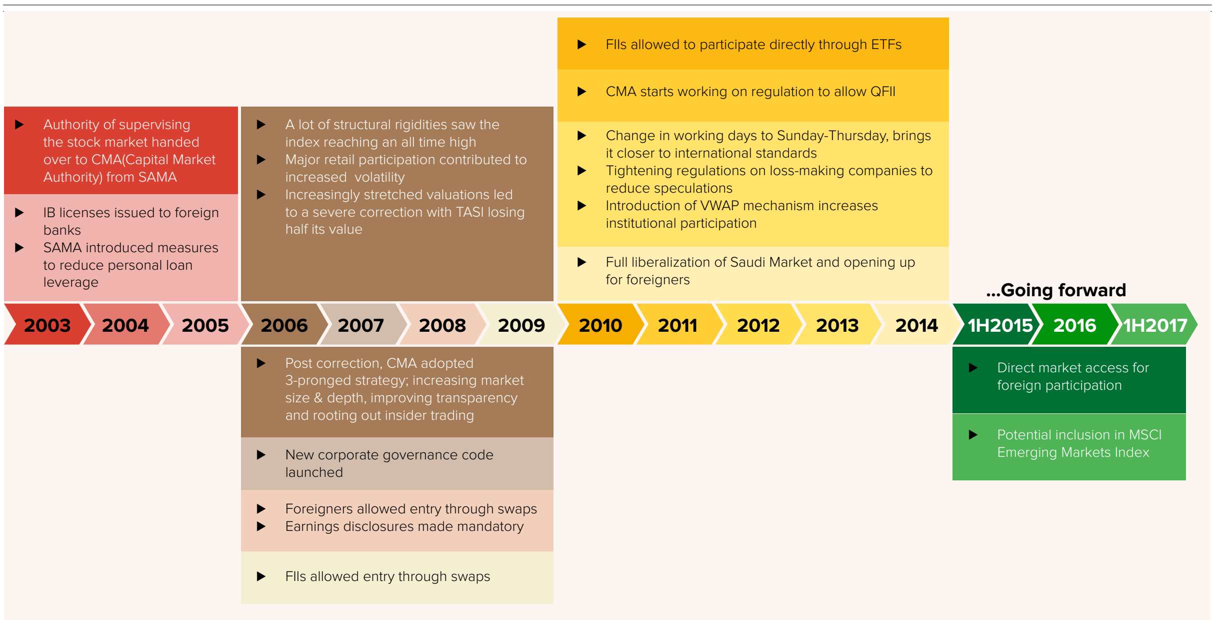
Saudi Arabia has come a long way in terms of developing its stock market, a crucial determinant to achieving an ambitious target. The country began to develop its stock market more than a decade ago, focusing on fundamentals such as transparency, disclosures, insider trading, and credit control, and recently switched gears focusing on raising it to international standards. On the economic front, Saudi Arabia remains the favorite among the G-20 nations, with stable GDP growth, high fiscal surplus and low debt levels, among others. The Kingdom scores high on other development parameters such as ease of doing business, investor protection and raising credit. Moreover, given its sovereign rating of AA- with positive outlook, the country is better than many developed and emerging economies. Another interesting aspect is that KSA is insusceptible to political crisis in the MENA region, as seen during the Arab Spring.

Evolution of investment regime in Tadawul indicates strong commitment to attract foreign capital

Robust institutional and regulatory framework and a proactive policy make Saudi Arabia one of the most attractive markets for global investors. Since the handing over of Tadawul's supervision to a separate body (Capital Market Authority) in 2003, the operational structure of the capital market has become robust, governance/transparency has improved, and policymaking has become effective. The Capital Market Authority's strategy to transform the stock market, as it looks to gradually open the capital market to foreign investments, can be summarized in three broad steps:

- » Removing irregularities in procedure and operations of the stock market, and focusing on the size and depth of the market
- » Paving way for foreign investments, albeit indirectly
- » Undertaking initiatives to complete the liberalization of Tadawul

Figure 4: Development of Tadawul



Source: Capital Market Authority, KSA, Aranca research

Market begins to stabilize with the pick-up in reforms from 2009

The Tadawul witnessed two major instances of volatility during FY03–09. A number of structural rigidities led to a run-up in prices which saw the Tadawul All Share Index (TASI) reach a record high of 20,635, with heavy retail participation cited as one of the reasons for the considerable volatility. Following the crash that wiped out nearly USD480bn and reduced the TASI to less than half its value, the CMA wasted no time in adopting a three-pronged strategy: increasing size and depth of the market, improving transparency and rooting out insider trading. Having identified the need for foreign institutional participation to reduce volatility, the authorities turned their focus on removing imbalances in the market and attracting FIIs. Some of the steps included permitting foreign participation through swaps, ETFs and changes in regulations to allow QFII. The second instance was smaller in magnitude and related more to the global financial crisis of 2008. The reforms that began with the partial opening of the market in 2009 decreased volatility and culminated recently with the full liberalization of the Saudi market.

Figure 5: Reduction in volatility from 2003 with the partial opening of the market in 2009

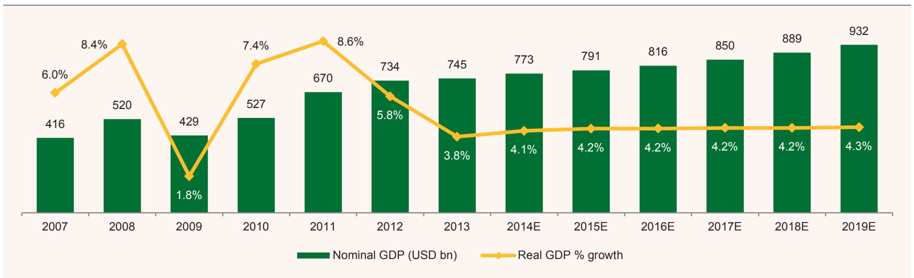
Source: Tadawul, Bloomberg

Saudi Arabia has sound economic fundamentals

Expected to continue growing at a decent pace

Saudi Arabia's economy has grown at an impressive rate over the past few years. Moreover, KSA is among the few countries that remained relatively immune to the global financial crisis, clocking an average GDP growth of 6%, third only to India and China. The IMF expects KSA's real GDP to continue growing at a modest (4–4.3%) but higher rate than advanced economies (2.3%).

Figure 6: Nominal GDP (USD bn) and Real GDP Growth % growth (2007–19E)

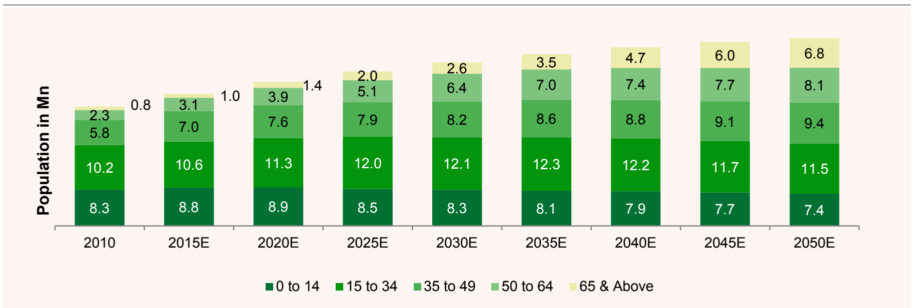


Source: IMF World Economic Outlook Database, April 2014

Favorable demographics key to sustained economic growth

With 65% of its total population below 34 years old (median age: 26 years), strong demographics is an important underlying strength of Saudi Arabia; this, we believe, is the key to sustained economic growth. Over the last few years, the Saudi government has laid emphasis on tapping the potential of its burgeoning youth population by spending on education and related areas (expenditure on education accounted for nearly 25% of 2013 budget; highest in the world) and simultaneously taking steps to boost employment in the private sector through various labor reforms.

Figure 7: Favorable demographics for sustained economic growth



Source: World Bank Database

Fiscal surplus, despite expansionary spending policy, led by influx of petrodollars

Saudi Arabia is expected to record a fiscal surplus for the fifth consecutive year in 2014 due to high oil prices and growth in oil production—oil revenues are expected to total USD329bn. This has enabled the Saudi government to maintain an expansionary fiscal policy to diversify the economy from oil. Therefore, despite the economy's heavy dependence on oil revenues, the non-oil sector's contribution to GDP has risen steadily, standing at 53% currently from 44% in 2008.

Figure 8: Government revenue and expenditure

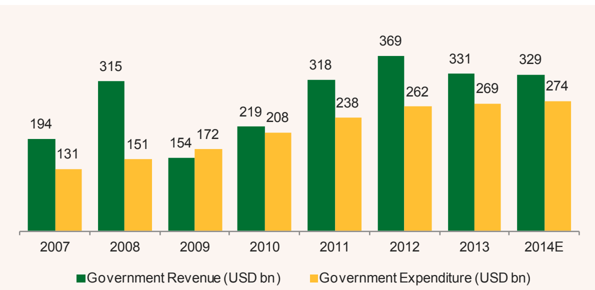
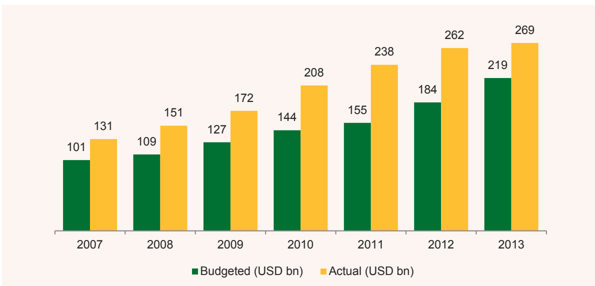


Figure 9: Budgeted vis-à-vis actual spending



Source: IMF World Economic Outlook Database, April 2014

Saudi Arabia's current account balance (CAB) is one of the largest in the world due to its dominance in oil export. The country's CAB, as a percentage of GDP, of 17% is well above that of developed economies such as the US (-2.7%) and UK (-3.8%) as well as emerging markets such as Brazil (-2.4%), China (2.3%) and India (-4.9%). Saudi Arabia has also brought down its debt to low single digit over the years; it currently stands at just 3% of GDP.

Figure 10: KSA's CAB one of the highest in the world

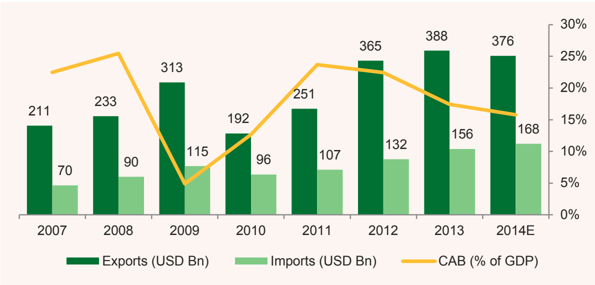
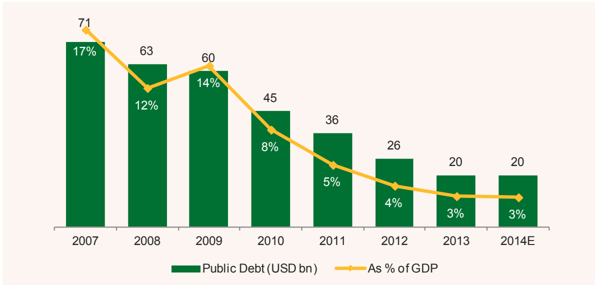


Figure 11: KSA's debt levels reduced drastically



Source: IMF World Economic Outlook Database, April 2014

Investor-friendly environment enhancing competitive strength

Saudi Arabia has a higher sovereign rating than most emerging markets; this reflects its strong fundamentals. S&P has given Saudi Arabia an 'AA-' rating with a positive outlook, just three notches below the maximum possible rating of 'AAA'. Moreover, KSA scores better in terms of ease of doing business, with strong investor protection laws and high availability of credit, among a host of parameters. The raising credit parameter reflects the collateral and bankruptcy laws that support lending and borrowing, whereas the investor protection parameter indicates strength in three areas: extent of disclosure, extent of director liability and ease of shareholder suits.

Figure 12: KSA's sovereign rating just two notches below highest

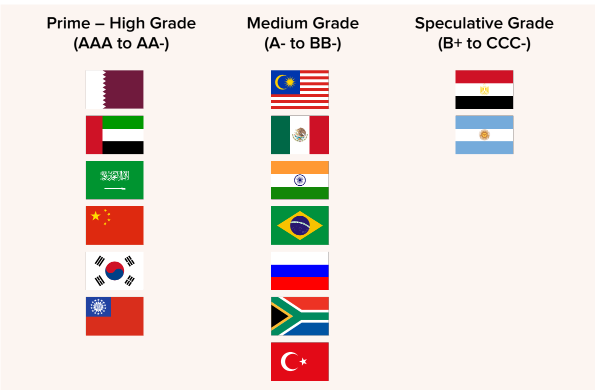


Figure 13: KSA among the most business-friendly economies in EM

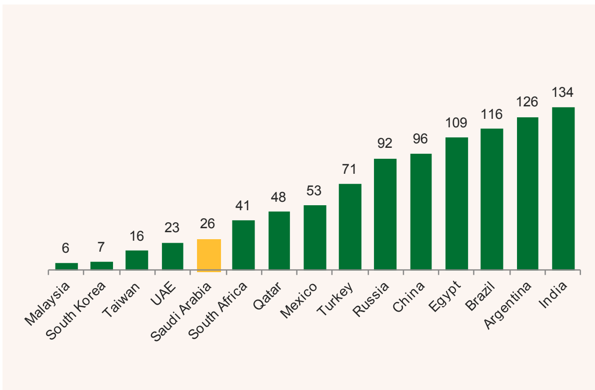


Figure 14: Getting credit in KSA easiest in MENA (rank 133)

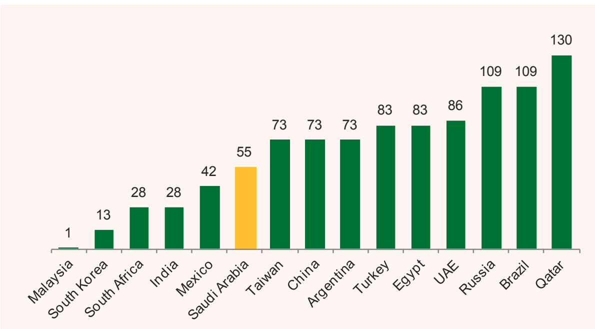
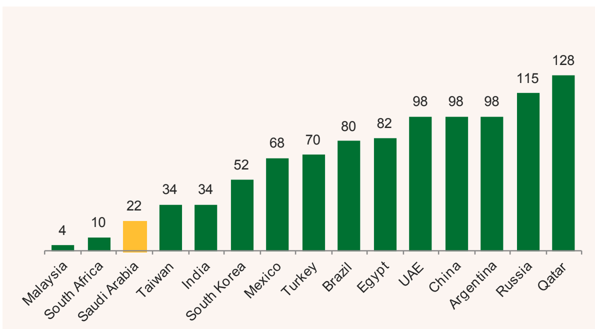


Figure 15: KSA offers strong investor protection

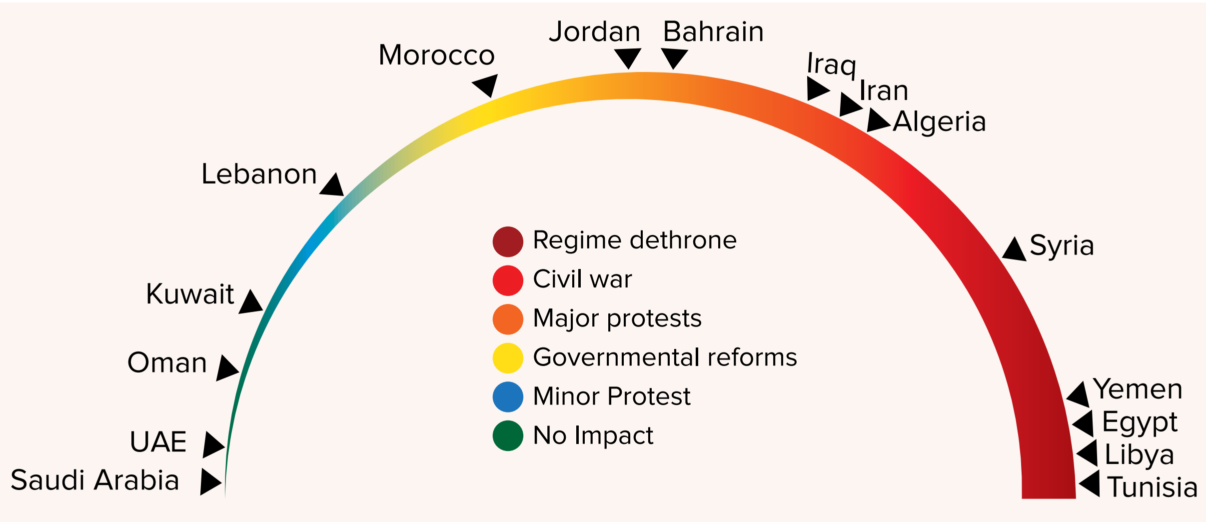


Source: S&P, World Bank, Rankings taken from Ease of Doing Business Report 2014

Unaffected by social unrest in MENA

Saudi Arabia was largely unaffected by the Arab uprisings that swept the MENA region. This was mainly due to the Saudi government's ability to satisfy the needs of its population. The Government of KSA implemented major labor reforms in 2011 that led to an increase in employment as well as salaries of nationals, ensuring stability. Factors such as economic development, satisfaction with the system of governance and emerging nationalism have held the nation together during turmoil and otherwise; consequently, investors are more confident about stability in the Kingdom.

Figure 16: Impact of Arab Spring in MENA (Saudi Arabia vis-à-vis other countries)



Source: Aranca research

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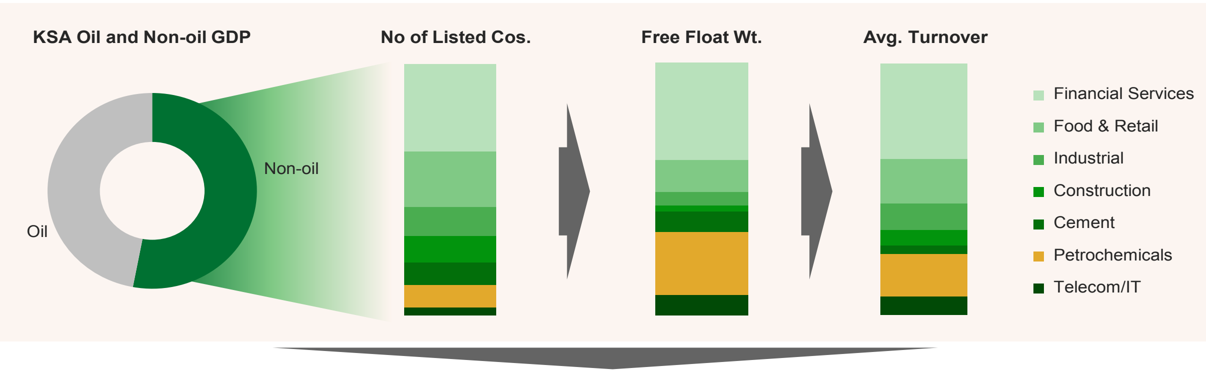
Tadawul providing a level playing field among many G-20 economies

Despite Saudi Arabia being an oil export economy, it offers investment opportunities across several non-oil sectors such as petrochemical, banking, telecom, food, retail, among others. We believe these opportunities would continue to increase as the country diversifies its economy further. The Saudi stock market (Tadawul) is fairly liquid and the most active IPO market in the MENA region, both in terms of value and listings. With just 169 listings, the market has an average monthly turnover of USD49.5bn—over 68 stocks (or 40% of total) have a market cap of more than USD1bn (and around 100 stocks with market cap of USD0.5bn or more); this places it above the stock markets in several G-20 nations. Furthermore, due to its low correlation with emerging countries, the Saudi stock market provides investors with diverse options. Therefore, we expect it to continue trading at a premium to the advanced and emerging market group averages.

Economic diversification creating investment opportunities across sectors

Saudi Arabia is an oil-driven economy, with the oil segment contributing more than 85% to total revenues and approximately 47% to the Kingdom's GDP. However, all companies in this space are unlisted. Hence, the Saudi stock market provides investors exposure to only non-oil companies across diverse sectors such as petrochemicals, financial, food, retail, among others. There are 169 listed companies in the Saudi stock market, with the financial sector having the highest free flow weightage, followed by petrochemicals and telecom. We believe further diversification of the economy would unlock more growth potential in the non-oil segment and benefit investors.

Figure 17: Non-oil segment provides ample opportunities for investors



Metrics of Key Sectors in TASI	Banking	Petrochemical	Food & Retail	Construction & Cement	Telecom
Sector Revenue (USD bn)	14.7	80.9	19.2	9.9	20.7
MCap as % of GDP	15%	21%	7%	5%	3%
Free Float MCap (USD bn)	61.4	51.1	28.7	25.1	10
No of Listed Cos	11	14	30	30	5
Daily Turnover (USD mn)	247	373	352	211	160
Volume as % of Total TASI	13%	16%	9%	8%	12%

Source: Tadawul, Bloomberg

Saudi stock market above several G-20 peers

With an average monthly turnover of USD49.5bn, the Tadawul is at par with most G-20 peers; in fact, it is competitively placed with the likes of Brazil, South Africa and Russia. The Saudi stock market's share turnover velocity ratio is 1.1 vis-à-vis Brazil's 0.57 and South Africa's 0.23. Furthermore, the Saudi stock market is fairly deep, with over 100 companies (or 59%) and more than 68 companies (or 40%) of the total 169 having a market cap above USD0.5bn and USD1bn, respectively. This is higher than the peer group average of 34% and 24%, respectively. Therefore, attractive blue-chip offerings and market depth make Saudi Arabia a lucrative destination for investments.

Figure 18: Tadawul – Provides an excellent depth to investors

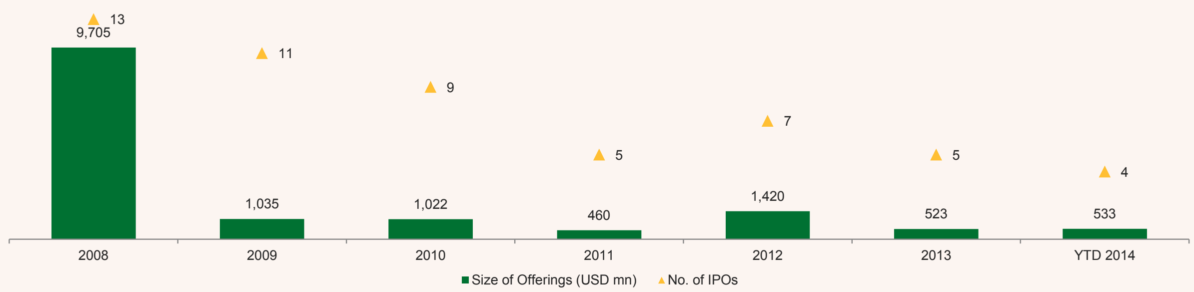
Country	Stock Exchange	MCap (USD bn)	Avg turnover (USD bn)	Share turnover velocity ratio	No of Listed Cos	No of Cos MCap>USD 1 bn	No of Cos MCap>USD 500 mn
Italy	Borsa Italiana	698	83.3	1.25	360	80	101
Brazil	BM&F Bovespa	1,100	55.7	0.57	369	117	160
Saudi Arabia	**Tadawul SE**	**530**	**49.5**	**1.1**	**169**	**68**	**100**
Turkey	Borsa Istanbul	223	31.4	1.8	231	40	72
South Africa	Johannesburg SE	1,028	28.3	0.23	375	86	118
Russia	Moscow Exchange	735	23.3	0.33	251	52	71
Mexico	Mexican Exchange	530	13.1	0.3	142	68	84
Indonesia	Indonesia SE	408	8.3	0.19	496	75	124
Argentina	Buenos Aires SE	56	0.3	0.09	104	11	20
Average		**590**	**32.6**	**0.65**	**277**	**66**	**94**

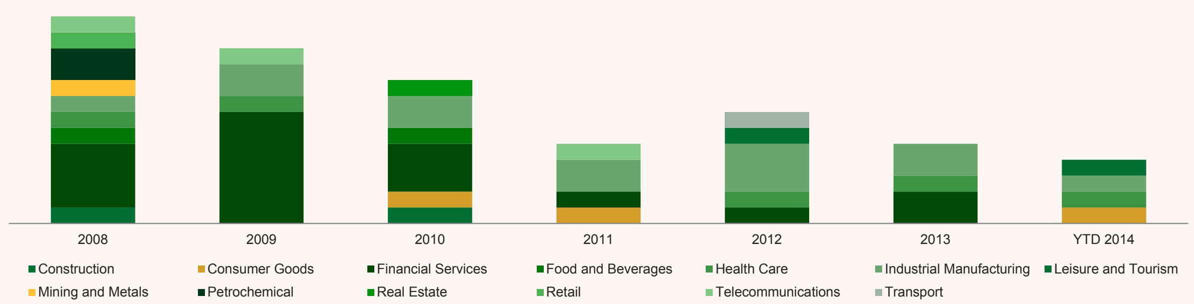
Source: Bloomberg, Aranca research

Robust IPO activity

Saudi Arabia is the largest IPO market in MENA, with 37 listings over the last five years (2009–13), followed by Tunisia (23) and Oman (8). It is also the biggest in terms of proceeds raised (USD5bn vis-à-vis USD0.5bn in Tunisia and USD1.2bn in Oman). Al Hammadi Company for Development and Investment (in the retail sector) was the last of the four IPOs in 2014 raising a total USD533mn (higher than USD523mn last year). We believe the potential remains strong, with more than 35 family-owned businesses in discussions with advisors for IPOs, and National Commercial Bank (NCB), the largest Saudi bank, likely to go public later this year. Al Rajhi, the second largest bank after NCB, has a market capitalization of USD30bn.

Figure 19: Saudi Arabia, largest IPO market in MENA (2008–14 YTD)



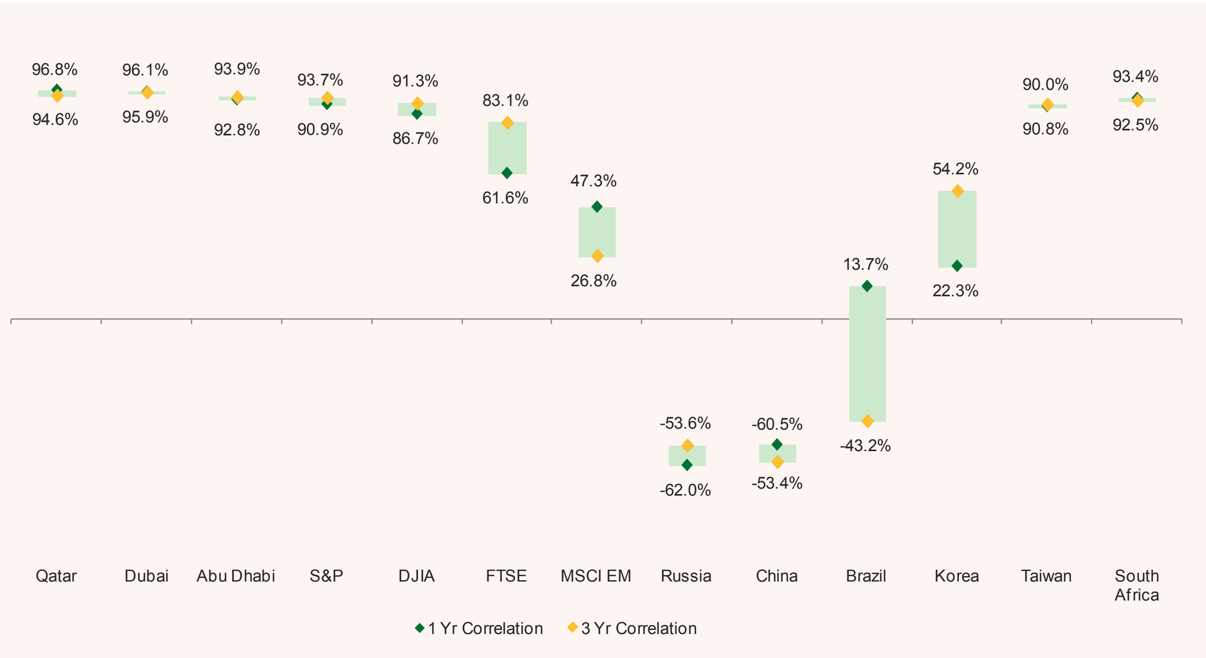


Source: Zawya, Aranca research

An attractive alternative to riskier emerging markets

Saudi Arabia's stock exchange provides significant diversification-related benefits to global investors due to its low correlation of 27% and 47% (1-year and 3-year) with the MSCI EM Index. Separately, Tadawul has a negative to low correlation with Russia, China, Brazil and South Korea. However, its correlation with the US market is high at 87–94%, given the dollar peg; we believe this bodes well for investors willing to bet on safe-haven dollar-denominated investments, as seen during the emerging market currency turmoil.

Figure 20: Diversification benefits due to low correlation with MSCI EM

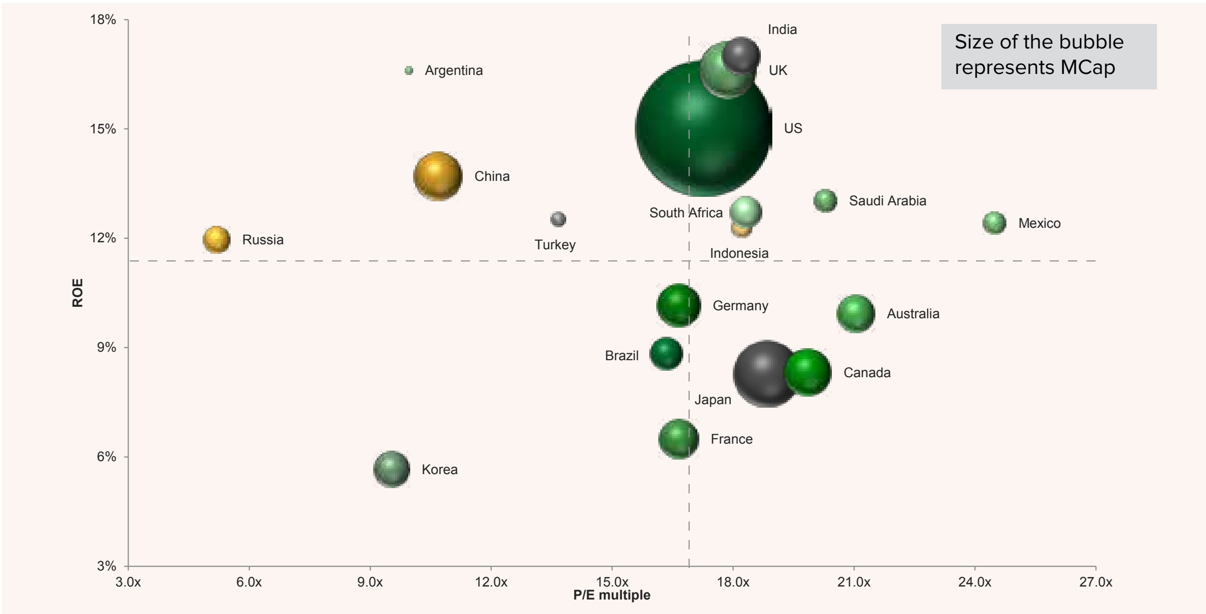


Source: Bloomberg, Aranca research

Strong fundamentals, growth potential warrant premium valuation

The Saudi stock market's return on equity (ROE) currently stands at 13%, higher than that of MSCI EM and MSCI ACWI (12% each). Furthermore, according to the consensus estimate, the earnings of listed Saudi firms would grow 13% in 2015, at a higher pace than the expected 11% average for both emerging as well as advanced economies. Also, at 3%, the Tadawul's dividend yield is higher than the 2.5–2.7% range for both MSCI EM and MSCI ACWI. We believe these factors, coupled with strong macroeconomic fundamentals, justify the premium valuation of 20x for the Saudi stock market versus 17x for MSCI ACWI.

Figure 21: Saudi Arabia's position among key developed and emerging countries



Source: Bloomberg, Aranca research

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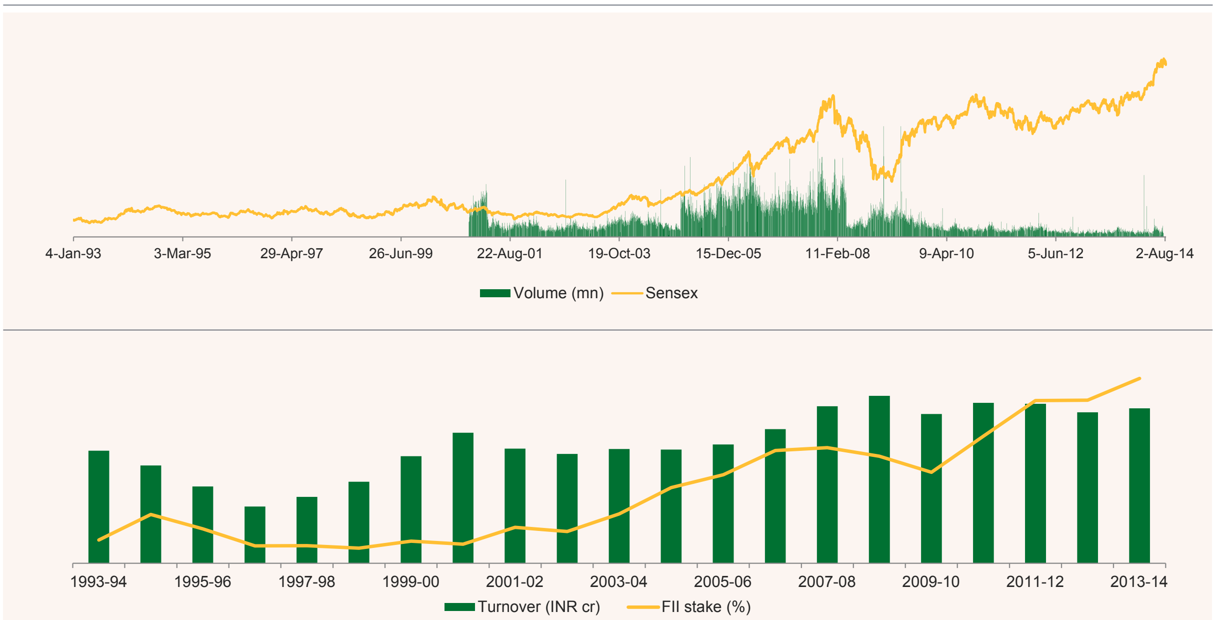
Other markets performed well after liberalization

Emerging markets such as India, Dubai and Qatar have witnessed positive results in the form of increase in market capitalization, investments and market activity after being opened to foreign institutional investors (FIIs). While the Indian market benefited from improved trading infrastructure and better corporate governance, which attracted a lot of FIIs, trading activity across the UAE and Qatar indices surged following their inclusion in the MSCI EM Index. Nine UAE and Ten Qatari stocks were included in the MSCI EM Index, which witnessed higher foreign participation in related sectors as well as increased foreign ownership in these stocks. The Government of Qatar raised the FOL to 49%; this is expected to result in higher foreign inflows and increase the weightage of Qatari stocks on the MSCI EM Index.

India: Stock market mainly driven by FIIs

Like Saudi Arabia, other emerging markets witnessed a boom in investments and market capitalization after opening their doors to FIIs. India's Sensex moved up to 26,000 from merely 2,000 in two decades due to huge foreign participation. The Indian market rose significantly after 2003 owing to the massive inflow of FII money following the development of trading infrastructure and improvement in corporate governance.

Figure 22: India: FII driving movement in index and volumes



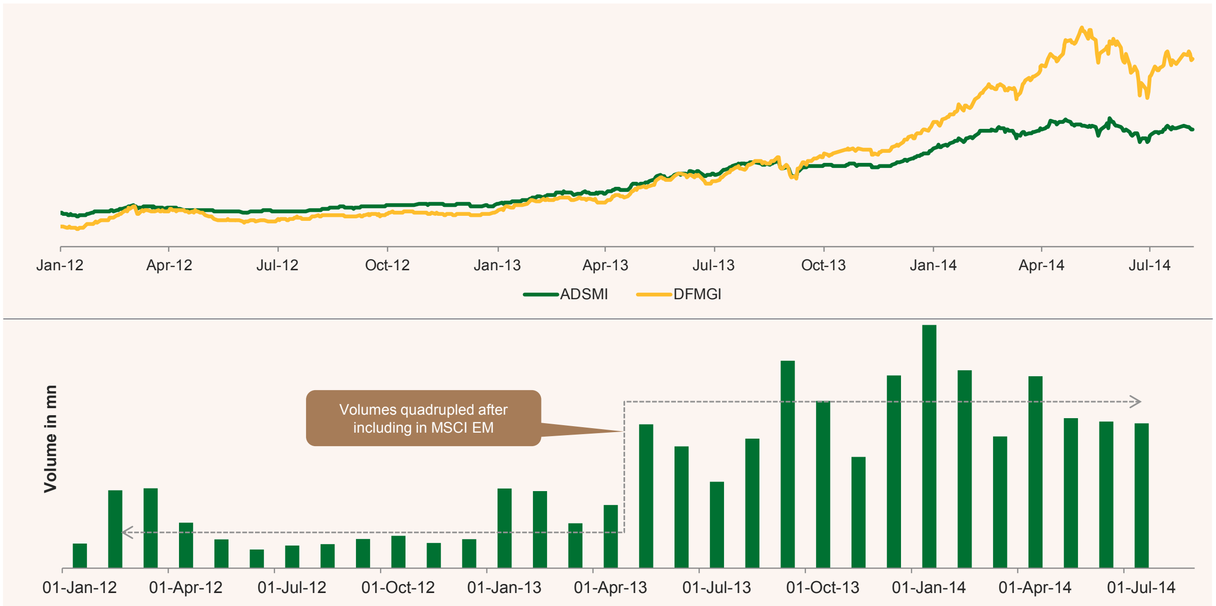
Source: Bloomberg, Bombay Stock Exchange, National Stock Exchange, Aranca research

UAE and Qatar: Included in MSCI EM Index in May 2014

Trading activity surges, foreign ownership rises in selected stocks in UAE

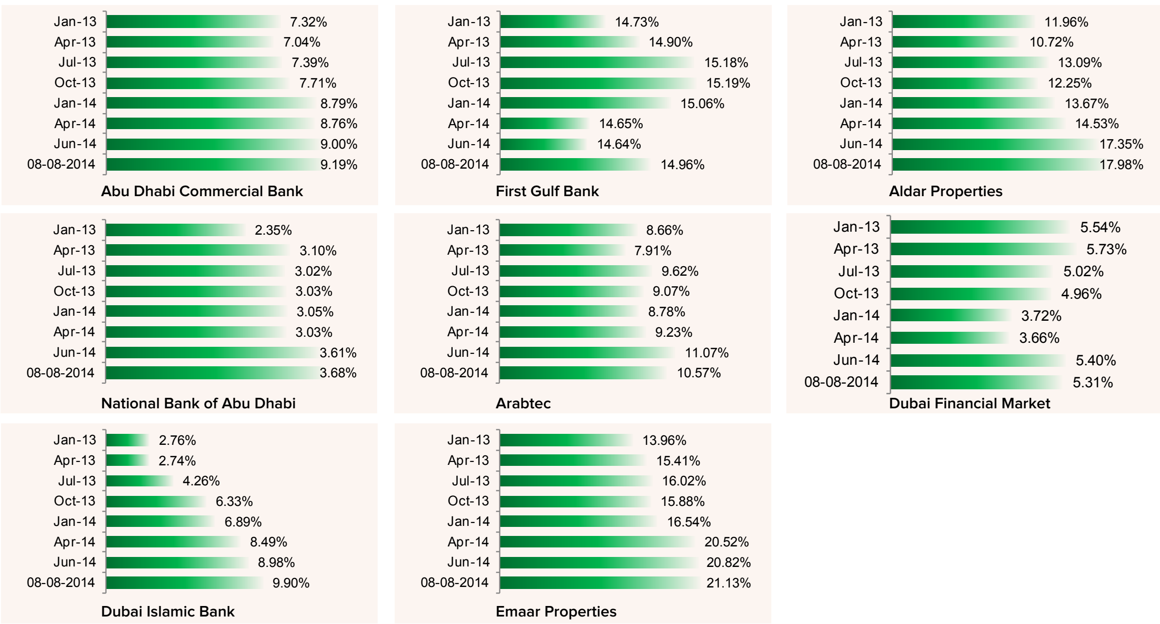
The UAE index rose significantly, while trading activity increased nearly fourfold after the country was included in the MSCI EM Index, the process for which began a year earlier in June 2013. Notably, Dubai Financial Market (DFM) reached a five-year high in May following the news of inclusion. In June 2014, four stocks of the Abu Dhabi Securities Exchange (ADX) – First Gulf Bank, National Bank of Abu Dhabi, Abu Dhabi Commercial Bank and Aldar Properties – and five stocks of DFM – Arabtec, DP World, Dubai Financial Market, Dubai Islamic Bank, and Emaar Properties – were included in the MSCI EM Index; this led to higher foreign participation in banking, financial services and real estate sectors.

Figure 23: UAE: Trading improves significantly after MSCI EM inclusion



Source: Bloomberg, UAE Stock Exchange websites, Aranca research

Figure 24: UAE: Increase in foreign shareholding in companies included in the MSCI EM Index

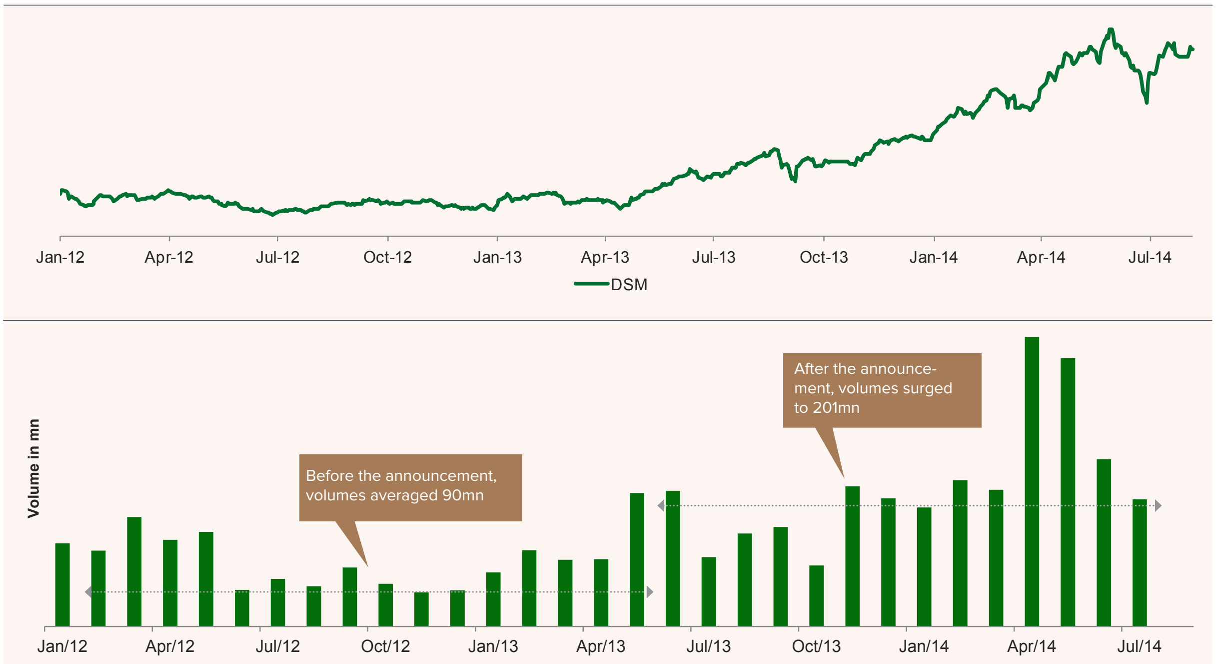


Source: Bloomberg, Stock Exchange website, Aranca research

Qatar performs on similar lines

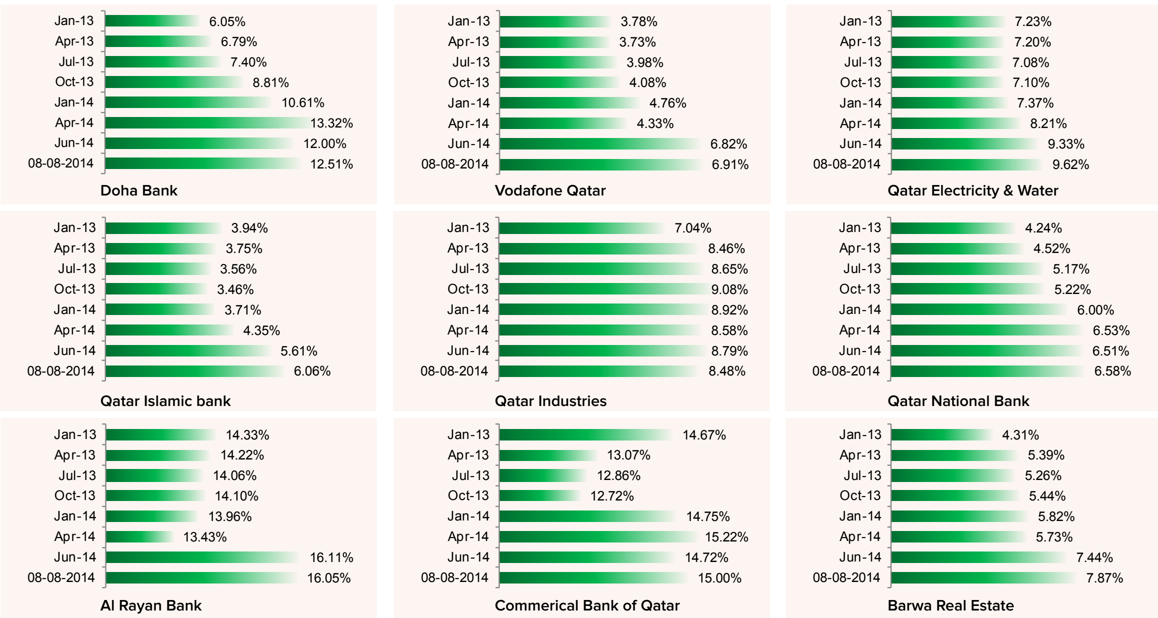
The Qatar Exchange (QE) index reached a lifetime high of 13,910 after inclusion of 10 stocks in the MSCI EM Index in June 2014. Furthermore, foreign ownership grew significantly in selected stocks. Recently, the government's decision to raise the foreign ownership limit (FOL) to 49% from 25% for listed companies strengthened investor sentiment. The rise in FOL is expected to not only help the country witness foreign inflow of approximately USD440mn but also increase the weightage of the index from 0.47% to 0.62% (higher than the UAE's 0.58%) on the MSCI EM Index in the near future.

Figure 25: Qatar: Rise in trading value and volume after inclusion in MSCI EM



Source: Bloomberg, Stock Exchange website, Aranca research

Figure 26: Qatar: Foreign shareholding in companies following inclusion in MSCI EM Index



Source: Bloomberg, Stock Exchange website, Aranca research

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Conclusion: Opening of market to lure huge foreign investments

Saudi Arabia took a landmark decision in July 2014 to allow direct foreign investment in Tadawul, the largest exchange so far restricted to outsiders. The Tadawul has a market cap of USD530bn, but a relatively lower MCap to GDP ratio of 0.71. On one hand, we expect the country's solid fundamentals to continue advancing on high oil prices, aided by the government's plan to diversify into the lucrative non-oil avenues. Capital Market Authority, on the other hand, is laying emphasis on bringing up its stock market reforms/policies/infrastructure at par with international standards.

The Tadawul's high credit rating, low correlation with peers in emerging markets, and relatively higher earnings have made it a favorite among investors. With monthly turnover averaging USD49.5bn and a velocity ratio of 1.1, the Tadawul is at par with exchanges in several G-20 countries. Moreover, more than 40% of companies listed on the Tadawul have a market cap of above USD1bn (59%+ with MCap > USD0.5bn). It is, in fact, the most active IPO market in the MENA region. The Saudi stock market is also fairly diversified across non-oil sectors, and this is expected to grow as it continues to focus on economic diversification.

Capital Market Authority expects the new rule to take effect some time in 1H 2015; our back of the envelope calculations suggest that the market cap could increase by USD150bn if MCap/GDP ratio improves by just 10bps. In our opinion, this is very significant, especially given that the Saudi market is likely to be included in the MSCI EM Index in 2017. A quick analysis of India, UAE and Qatar reveals that these nations significantly benefited – in terms of market activity (volumes, turnover, index movement) as well as rise in foreign ownership – after opening their stock market to foreign investors. We foresee the same results for Saudi Arabia.

Contact Us

Europe, Middle East & Africa
London
93-95 Gloucester Place
London W1U 6JQ
T: +44 (0) 207 487 8214

Americas
New York
275 Madison Avenue, 6th Floor,
New York, NY 10016
T: +1 212 878 8826

Asia & Rest of World
India
Supreme Business Park,
Hiranandani Gardens, Powai
Mumbai 400 076
T: +91 (22) 3937 9999

www.aranca.com
info@aranca.com