جدوى للإستثمار
Jadwa Investment

August 2014

# Opening the Tawadul up to Foreign Investors

## Overview

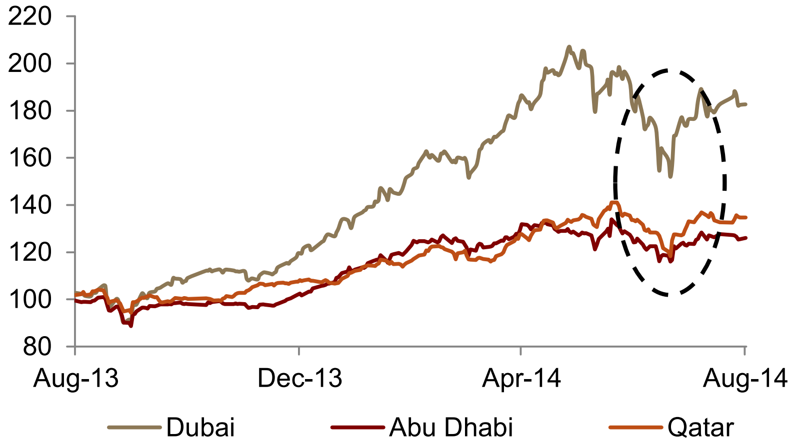
The announcement in late July 2014 by the Council of Ministers that foreign investors would be allowed to invest directly in the Tadawul came as no surprise. The Saudi Arabian index is the region's most diverse capital market due to its size and maturity, and has been gearing up to welcome foreign investors for some time now. Although foreign investors have been able to access the Tadawul through indirect routes, via swaps and exchange-traded funds, allowing direct foreign ownership will be a key milestone for the development of Saudi Arabian capital markets and indeed the wider economy. Jadwa Investment views the opening up of the Tadawul as an overall positive but we believe a cautious and considered path to reform is the best way forward, much like the Chinese example.

According to the draft proposals released by the Capital Markets Authority (CMA) any Qualified Foreign Investor (QFI) 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. Other limitations apply, including:

- 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 QFI's) have a combined ceiling of 49 percent ownership of issued shares, in any one listed company.
- QFI's together can only own a maximum of 20 percent of issued shares of any one listed company.
- Swaps and QFI's can only own up to a maximum of 10 percent of aggregate stock market value of all listed companies.

Below are some of the main issues that we believe need to be considered leading up to and after opening the Tadawul.

**Figure 1: Qatar & UAE markets & MSCI inclusion**




Rebased to 100 at August 2013

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## Short to medium-term outlook

*The opening and eventual inclusion of the Tadawul into MSCI raises the risks of over pricing.*

The opening and eventual inclusion of the Tadawul into MSCI raises the risks of over pricing of stocks in the short to medium term. With the greater dominance of retail investors and their higher risk appetite, there is a strong possibility that the Tadawul could move beyond fair value levels. With the Saudi stock exchange expected to be included into the MSCI Emerging Markets Index by 2017, a similar pattern of events could occur to what was seen in Qatar and the UAE. Both countries stock markets 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 1).

*There are already signs that the TASI is moving towards being over heated.*

There are already signs that the Tadawul All Share Index (TASI) is moving towards being over heated, having risen over 10 percent since the announcement on July 21. Furthermore, current price/ earnings (PE) valuations are trending above the long term average, with PE at 20.4 in early August, although it still below previous peaks of 27.4, in mid 2006 (Figure 2).

*The surge in optimism fuelling the current TASI rise is not based wholly on speculative gain or positive sentiment, also underpinned by strong economic fundamentals.*

It is important to highlight, however, that the surge in optimism fuelling the current TASI rise is not based wholly on speculative gain or positive sentiment, it is also a due to a flourishing Saudi economy, which is underpinned by strong economic fundamentals.

*The outlook for the Tadawul remains very positive in the short to medium term.*

We see governmental spending plus stable international oil prices maintaining elevated levels of business and investor confidence, going forward. Sectors with strong linkages to the domestic economy, such as construction, transportation, retail and manufacturing, will continue to perform well, but so will the two largest sectors, banking and petrochemicals. The banking sector is riding high from soaring consumer lending and a widely anticipated rise in US interest rates will add to future profitability. The petrochemicals sector continues to benefit from low feedstock prices, which means it is well placed to benefit from an upturn in demand as the global economy picks up.

**Figure 2: TASI Price/Earnings Trending Upwards**

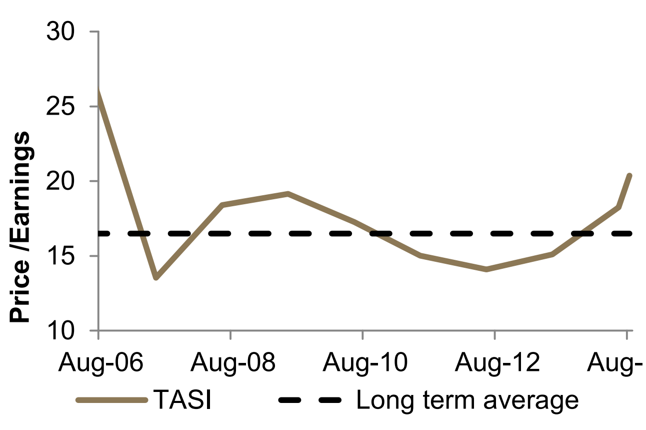
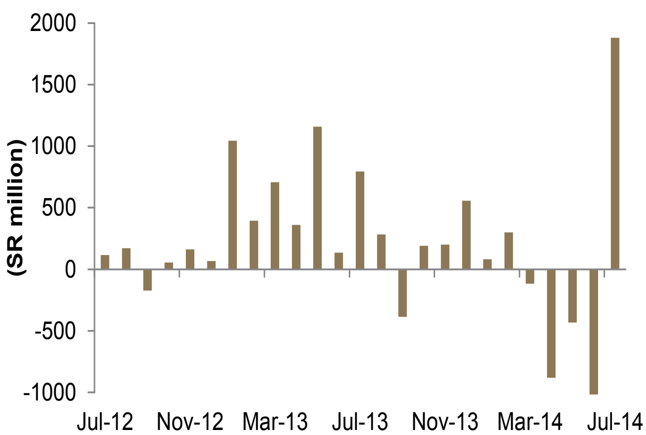



**Figure 3: Net purchases of Swap agreements**



## Strong foreign participation expected

*Currently, foreign ownership of Saudi stocks amounts to around USD8 billion, or 1.4 percent of market capitalization of USD580 billion…*

The Saudi stock market opening has been highly anticipated for some time by foreign investors, and rightly so. The stock market has a number of exceptional companies, none more so than the petrochemical giant SABIC. Currently, foreign ownership of Saudi stocks amounts to around USD8 billion, or 1.4 percent of market capitalization of USD580 billion. With the Tadawul viewed as one of the final major global equity markets to open up, we anticipate foreign inflows to be strong immediately after it opens to QFI's in H1 2015 for the following reasons.

*...we expect foreign participation in the Tadawul to be very strong immediately after it opens to QFI's in H1 2015.*

Swap purchases up

A key indicator of the interest generated by the Tadawul's opening is highlighted by the surge in the value of shares bought by foreign investors, via swap agreements, immediately following the announcement to open up. Swap agreements reached record levels in July (Figure 3). The large positive swing in purchases of swaps demonstrates that investors are positioning themselves before direct foreign ownership takes place, as they realize prices may be less attractive once the Tawadul opens up.

*Surge in swap agreements is demonstrating that foreign investors are positioning themselves before direct foreign ownership takes place.*

Lower transaction costs

Foreign institutional investors are likely to have lower trading fees once they are able to buy directly into Saudi Arabia's stock exchange. Swap agreements are more expensive for foreign investors when compared to direct cash transactions since local brokers buy the stock on behalf of the foreign investor and charge for custody and brokerage. International banks holding a licenses to offer swaps charge around 25 basis points (0.25 percent). As the market opens up, foreign investors will benefit from lower transactions cost through direct access to stocks, resulting in transaction fees dropping to 12 basis points (0.12 percent). In addition to this, foreigners investing in the Saudi stock market will reap the benefits of a zero tax liability on capital gains and a withholding tax rate of 5 percent on dividend payments, which is amongst the lowest, globally (Figure 4).

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*Beyond the short term we believe that total foreign inflows could total between USD40-50 billion.*

Beyond the short term we believe that total foreign inflows could total between USD40-50 billion, but this will only be the case if active investors feel there is value to be had in Saudi stocks.

**Figure 4: Favorable Dividend Withholding Tax**

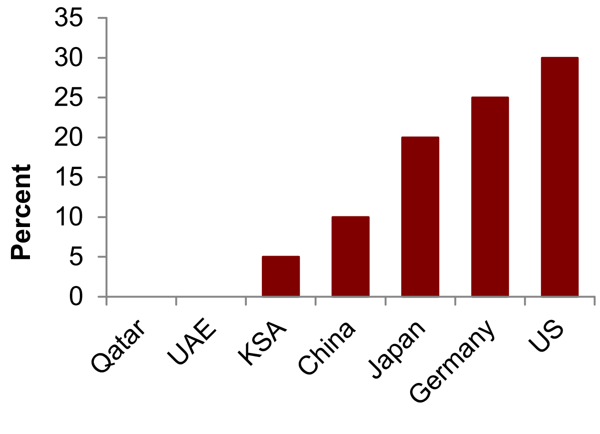
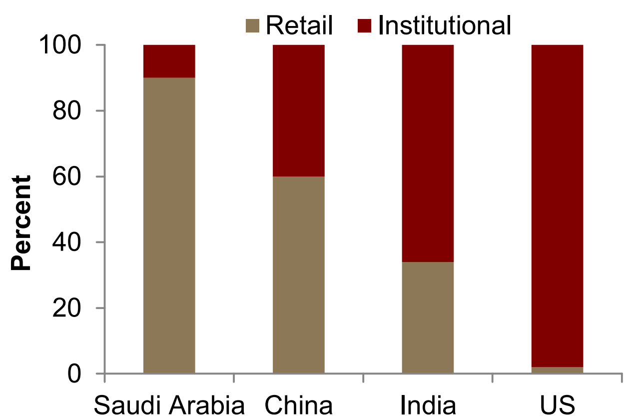



**Figure 5: Traded Volumes Retail vs. Institutional**



## Increasing role of institutional investors

*The Saudi stock exchange's trading volume is dominated by local retail investors…*

*...much higher than other large emerging market indices and well above the proportions seen in the US.*

The Saudi stock exchange's trading activity is dominated by local retail investors. According to the CMA, at the end of 2013 around 4.3 million retail investors had invested in listed companies, holding around a third of total listed Tadawul shares by value. Currently, retail investors in Saudi Arabia account for a higher proportion of traded volumes when compared to other large emerging market indices. In China, retail investors account for 60 percent of stock market volume, down from around 90 percent in 2003, prior to opening the market, whilst Indian retail trade volumes account for around 34 percent, with retail investor volumes much smaller in the US, where they account for less than 2 percent (Figure 5).

*Retail investors, in general, tend to have larger risk appetites and shorter investment horizons.*

Retail investors, in general, tend to have larger risk appetites and shorter investment horizons compared to their institutional counterparts. In the Saudi stock exchange, retail investors look to make shorter term profits by focusing on smaller sectors in the stock market, which are more susceptible to price movements, and, by doing so, have added to volatility within these sectors. For example, the smallest three sectors in the TASI, by net income, have exhibited much more volatility when compared to larger sectors (Figure 6 & 7).

*The CMA's draft proposals have only approved institutional investors and not individual investors...*

*...which we believe indicates that opening up of the Saudi stock market is an initial step towards more developed stock markets, where institutional investors are more prevalent.*

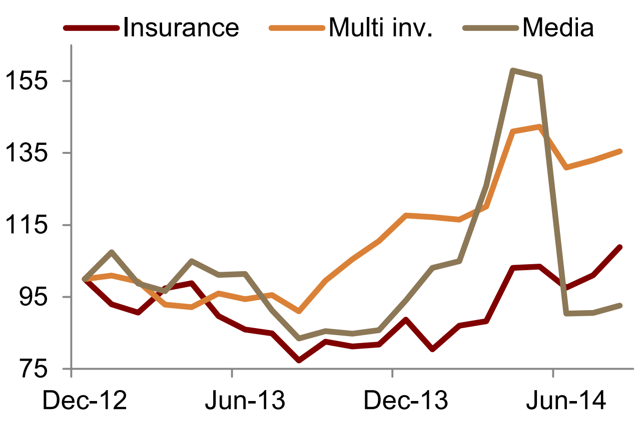
The CMA's draft proposals have only approved institutional investors and not individual investors. Institutional investors, in general, play an important role in developing financial markets since they act as conduit to channel individual savings into capital markets through longer term investment horizons. 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.

## Oil prices and the stock market

*Although the recent correlation between oil prices and TASI is low, major trends in the price of oil can impact investor sentiment and therefore the TASI.*

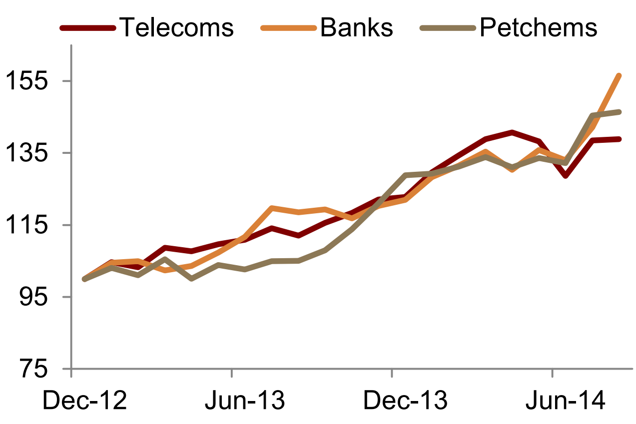
Although the recent correlation between oil prices and TASI is low, major trends in the price of oil nevertheless impact upon local investor sentiment, which can have corresponding movements in the TASI. Looking back we can pin-point some major global incidents that have directly impacted oil prices and, in turn, resulted in

**Figure 6: Higher Volatility in Smaller sectors…**




Rebased to 100 at December 2012

**Figure 7: ...Compared to Larger Sectors**

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*How is foreign investor sentiment likely to react to oil market movements that are dictated by regional geopolitical developments?...*

movements in the TASI. In chronological order, a major drop in oil prices following the global financial crises saw the TASI fall, although it was not alone, with reverberations felt throughout global equity markets. Secondly, the fallout of the Euro-zone crises, particularly the Greek debt crisis, resulted in oil prices dropping, the TASI also dropped to below the 6,000 mark around the same time, but again this was also the case in global equity markets. Finally, in the last two year we have witnessed a sustained period of high oil prices, above $100 per barrel, largely due to geopolitical events in the Middle East and Ukraine. This period of elevated prices has added to positive sentiments and helped lift the TASI benchmark by 38 percent since August 2013 (Figure 8).

*...very positively! Since Saudi Arabia's continued stability and sustained economic growth will allow investors to differentiate it from other troubled regional economies.*

With such a strong sentimental link between oil prices and stock market performance, there are obvious implications, perhaps in more faster and sharper movements in the TASI, once it is open to foreign investors. More specifically, a key question is how foreign investor's sentiments are likely to react to oil market movements that are dictated by regional geopolitical developments. Due to the centrality of Saudi Arabia to global energy markets, and the global economy, major investors, we believe, will continue investing in the country regardless of regional instability. 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 and deliver economic growth, through its own resources, has become apparent. In any case, even in instances where regional political uncertainty negatively effects investor confidence and the Saudi stock market, we expect such sentimental impact not only to be short lived, but also having the effect of driving up oil prices (see 'Arab Civil Unrest' in Figure 8) and Saudi crude oil production, thereby supporting both sovereign and external positions of Saudi Arabia, and ultimately having a positive impact on the stock market.

*Even in instances where regional events negatively effects investor confidence, it will be short lived.*

## Towards increased efficiency & transparency

*Opening up the stock market could improve overall efficiency in the way Saudi companies are run…*

We see an improvement in overall efficiency in the way companies are run, particularly through the more efficient use of assets, as a possible benefit of opening up the stock market. Since the financial crisis, return on equity (RoE) of Saudi listed companies has trended downwards (Figure 9). Profit margins have also declined but still

**Figure 8: Oil Prices and the Saudi Stock Market**

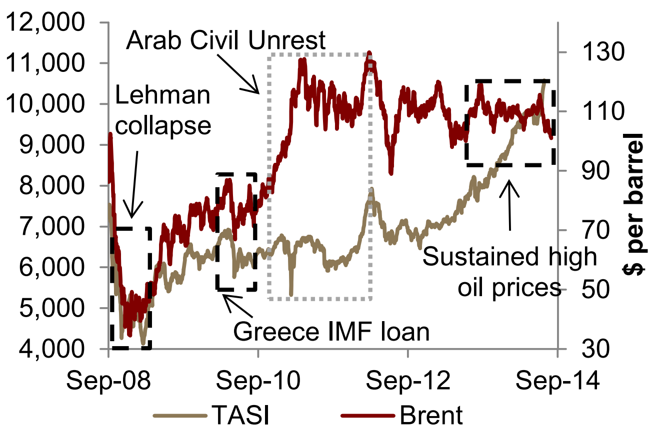
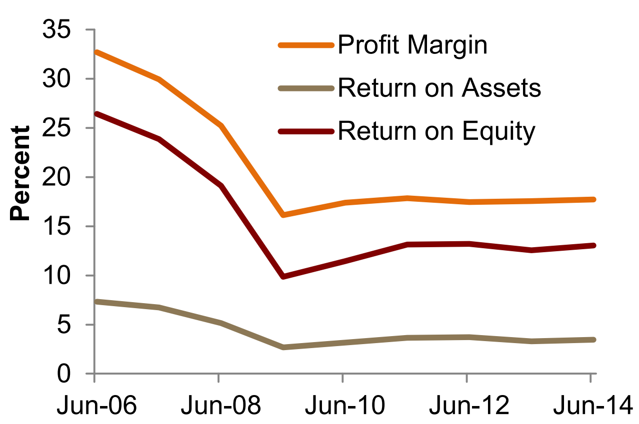



**Figure 9: Key Tadawul valuation metrics**



*...as foreign investors will become more active shareholders and hold management accountable.*

remain higher than the US and Europe, whereas RoE is comparatively average (Figure 10). Profit margins in Saudi Arabia are propped up by the lack of competition in certain sectors, some of which also benefit from government support, either directly or indirectly. In this context, low RoE and high profit margins suggest assets are not being used effectively to maximize sales. In the longer term, as foreign investors take up stakes in Saudi companies, and hold management accountable for strategic decisions, this will, in turn, promote improvements in efficiency, including an improvement in the use of assets in generating sales and ultimately increasing RoE. Therefore, when the Saudi government does eventually decrease the level of support to some sectors, such companies will be better placed to maintain profits, as the higher level of RoE will attract more investors.

*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 economic information.*

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 economic 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.

## China's slow but steady approach

*We believe that opening of the stock market in China offers a good example, defined by a more restrictive and cautionary approach.*

The CMA draft rules on opening up to foreign investors are in line with stock market openings of other countries (Table 1) but China's approach, in particular, offers a good example of a gradual and cautious opening. Just like the CMA in Saudi Arabia, the China Securities Regulatory Commission (CSRC) has been highly selective in its choice of foreign investors, allowing only large and experienced institutional investors to participate. Since opening up the Shanghai Stock Exchange (SSE) to foreign investors via the Qualified Foreign Institutional Investor (QFII) program, in 2003, progress has been slow but steady, with 229 QFII's being approved since opening. Back in July 2013, the China Securities Regulatory Commission (CSRC) announced that the QFII program would increase to USD150 billion, representing just over 5 percent of SSE's market capitalization. As of mid-2014, roughly one third of the total USD150 billion had been allocated to specific investment companies since 2003 (Figure 11). Furthermore, the CSRC has restrictions on investors that it deems contribute to stock market volatility, including hedge funds.

**Figure 10: Comparing valuation metrics**

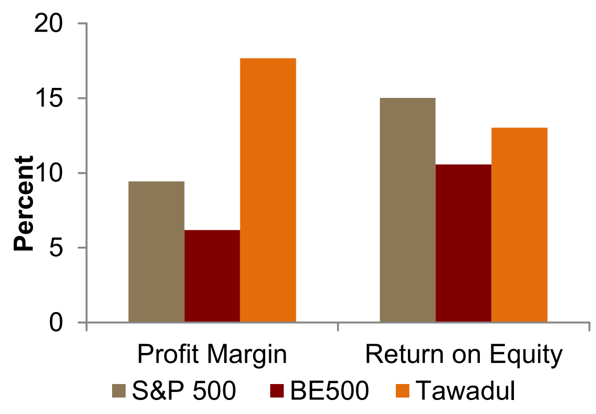



**Figure 11: China's slow but steady inclusion**

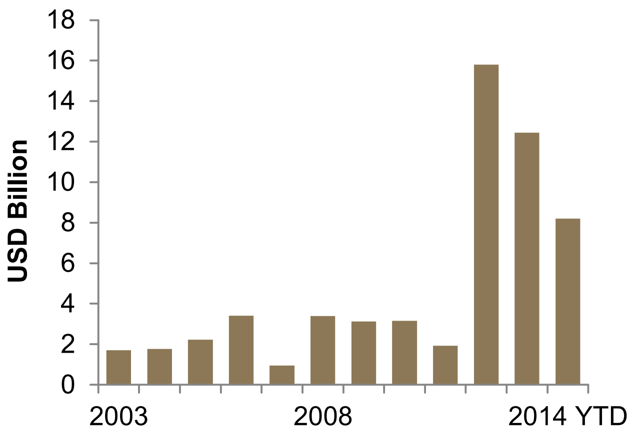


**Table 1: Comparative QFII Criteria**

| | Minimum criteria for QFI's | Max. foreign institutional ownership of stock | Total investment limit for QFI's | Max. limit for each QFI for single stock | Market Cap. |
|---|---|---|---|---|---|
| Saudi Arabia | $5bn AUM & 5 yrs experience | 20% | 10% of stock market value | 5% | $0.58 tr |
| China | $500mn AUM & 3 yrs experience | 30% | $150bn | 10% | $2.7 tr |
| India | $2bn AUM & average net profit of $50mn last 3 yrs | Sectorial caps e.g. IT 100%, Insurance 25% | 10% of stock market value | 5% | $1.32 tr |