SAUDI ARABIA

THE OPPORTUNITIES AND CHALLENGES OF A POTENTIAL MSCI CLASSIFICATION UPGRADE

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MSCI Inc. announced in June 2017 that is to open a consultation into the status of the Tadawul in its market classifications, with the potential for Saudi Arabia to be officially recognised as an emerging market as early as June 2018.

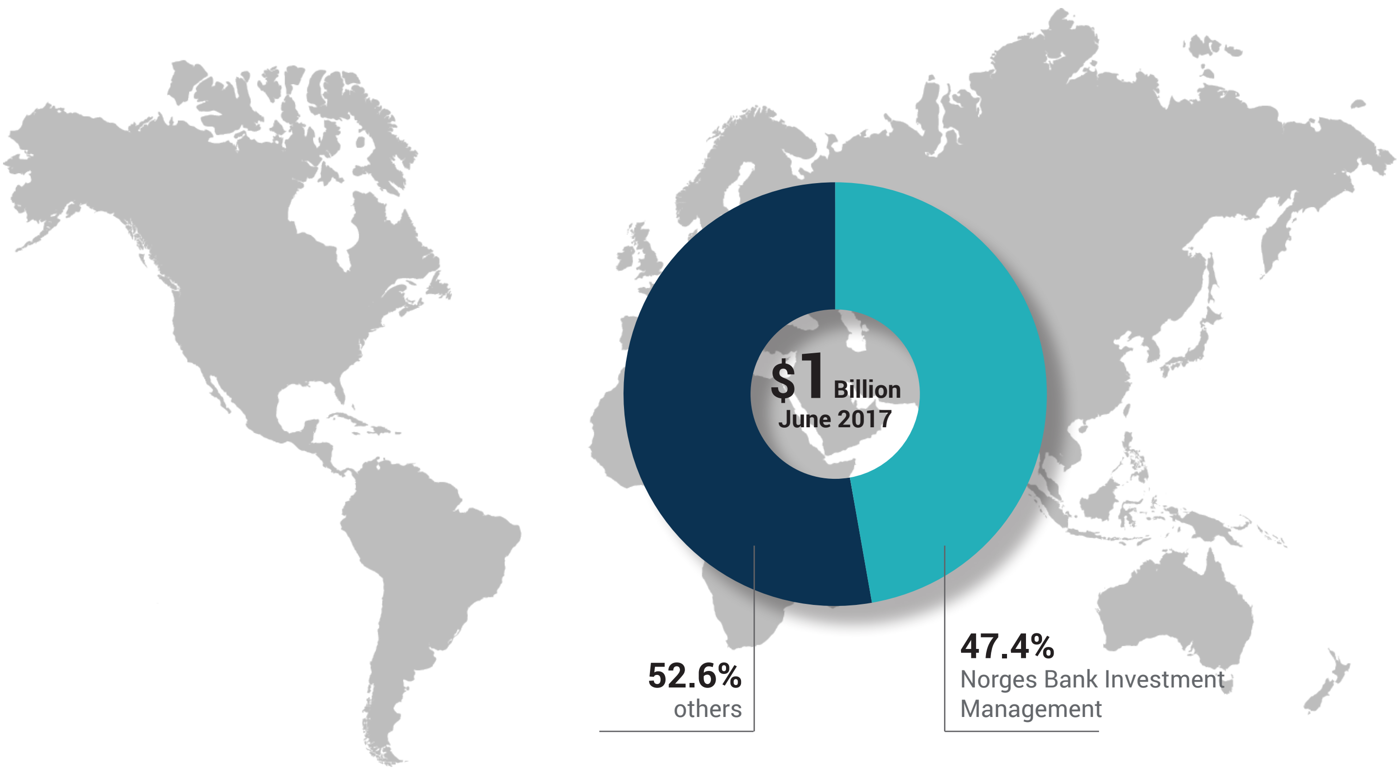
Whilst the consultation is ongoing, attention turns to the implications for the market's issuers should an accession happen. How much more capital would flow into the region? How can all Saudi issuers look to capitalise on it? What would it mean for investment into the GCC region as a whole?

The current investment landscape

As of June 2017, filed ownership records indicate that just over $1 billion is invested in Saudi Arabia by foreign entities. Very close to half of this comes from the Norwegian Government Pension Fund, managed by sovereign wealth fund Norges Bank Investment Management. Just 42 other internationally-domiciled funds have current exposure to Saudi equities, as the lack of Saudi issuers quoted within the emerging or frontier markets indices' company baskets essentially means that, with a couple of minor exceptions, only GCC or Middle East-focused funds have invested in them to date.

Even then, there are several such overseas funds that combine GCC investments with investments into North Africa or other emerging and frontier markets, and these naturally focus on the markets that they understand best and have been covering in depth for the long term. This puts Saudi Arabia at a further disadvantage as compared to the likes of the UAE and Qatar, that are already classified as emerging markets and have seen an established investment community develop.

A potential classification upgrade would then naturally result in greater interest from foreign investors, and therefore the potential for accelerated growth, as Saudi Arabian stocks will be included for the first time in MSCI's Emerging Markets Index, by far the most widely-tracked emerging markets index globally, and other major emerging markets indices will most likely follow suit. But how significant will Saudi Arabia's relative influence in these indices be, and what could that mean in terms of investment inflows? To assess this, the next section of this paper forms a top-level SWOT analysis.



Foreign Investments in Saudi Arabian Equities

The Strength: The size of the Tadawul

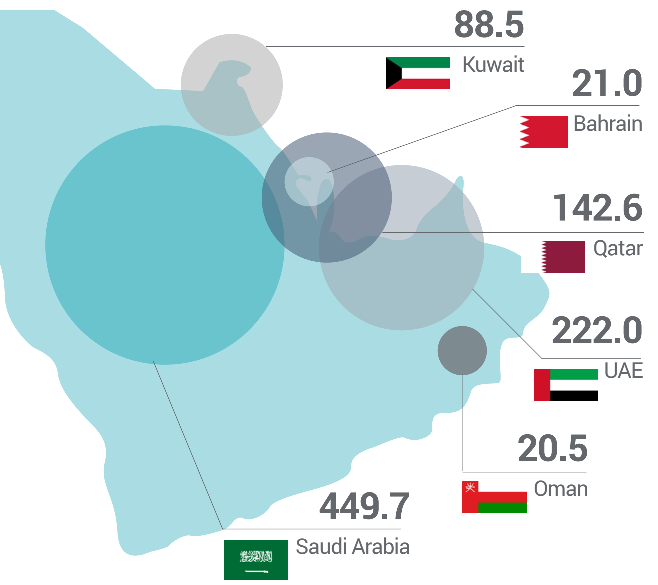
As of 30th June 2017, the Tadawul had a larger overall market capitalisation than all but eight of the current emerging markets, and is comfortably the largest of the GCC exchanges.

However, should an inclusion within emerging markets status occur, the key assessment criteria that MSCI will use for weighting Saudi Arabia against the other emerging markets will be free float market capitalisation. Therefore, the fact that some major domestic issuers have low free float proportions inevitably impacts on this, and yet Saudi Arabia would still be the ninth-largest of the emerging markets on current combined free float market capitalisations, as Table 1 shows.

One other obvious indicator of the size of Saudi Arabia's free float market capitalisation relative to the other GCC markets is in MSCI's own GCC Countries Index, in which Saudi Arabia's current weighting is 60%, four times greater than the next largest market, the UAE.

Moreover, a further boost to the overall size of Saudi Arabia is anticipated with the public listing of Saudi Aramco, which will increase the overall free float market cap consideration, although this looks set to occur after MSCI takes its decision. Either way, Saudi Arabia would, critically, have a significantly larger free float market cap than the UAE and Qatar, the existing GCC region emerging markets, consequently making Saudi Arabia the clear leader in terms of emerging markets investor interest in the Middle East.

FIGURE 1
Market capitalisation comparison of GCC nations' stock exchanges $ Bn



Source: World Federation of Exchanges, July 31st 2017, GulfBase Kuwait Market News, July 2017

TABLE 1
Total free float market capitalisations of emerging markets relative to Saudi Arabia

Rank	Country	Free float market cap ($B)	% of total EM free float
1	China	4,588.0	46.8%
2	India	881.3	9.0%
3	South Korea	864.0	8.8%
4	Taiwan	758.3	7.7%
5	Brazil	502.1	5.1%
6	South Africa	372.4	3.8%
7	Mexico	274.5	2.8%
8	Russia	217.0	2.2%
	Saudi Arabia	*197.9*	*2.0%*
9	Thailand	192.3	2.0%
10	Indonesia	167.9	1.7%
13	*United Arab Emirates*	*106.8*	*1.1%*
18	*Qatar*	*80.8*	*0.8%*

Source: Bloomberg, Fairvue Partners internal research

The Weakness:
Accessibility of the market

Logically, the relative sizes shown in Table 2 imply that Saudi Arabia's eventual weighting will be somewhere close to Russia's, and some early estimations have projected Saudi Arabia's weighting in the MSCI Emerging Markets Index, should inclusion occur in 2018, to be at around 2.5%.

Applying free float market capitalisation to the current market size relative to the 24 other emerging markets would mean that Saudi Arabia's weighting would be approximately 2.0%. However, this is not the full picture. MSCI will also take into account the 49% restriction on ownership from foreign investors and Saudi Arabia's weighting is likely to be discounted as a result. Market accessibility can have a significant bearing on the relative strength of each individual country within the index. One illustration of this is China's MSCI weighting, which is approximately 60% of its comparative free float market cap in part because of similar restrictions on foreign investment, although its dominant size and dual listings of its issuers in Hong Kong are also factors in this.[1]

In addition, the weightings ascribed to both the UAE and Qatar are also slightly below their intrinsic levels based on free float market cap, even now, a couple of years after their own upgrades.

As shown earlier, Saudi Arabia has a significant size advantage over the other GCC markets and, when applying the MSCI GCC Index methodology, looks to be well-placed for an eventual weighting close to 3% of the MSCI Emerging Markets Index. At first, however, a discount can be expected, and this may persist over the medium term depending on how the framework for foreign investment set in place by the CMA develops.

As a result, should Saudi Arabia be reclassified, whilst it is difficult to accurately quantify how MSCI will apply their methodology within its Emerging Markets Index, a more realistic expectation perhaps would be an initial country weighting in the range of 1.2% – 1.5%, with greater potential upside to follow as the market matures and greater levels of foreign investment are secured, notwithstanding the envisaged positive impact from a Saudi Aramco IPO.

[1] *This will rebalance slightly as the China A Share market is officially recognised within the emerging markets, although the overall uptick is projected to be an increased weighting of China in the index by approximately 0.7%.*

FIGURE 2
Top ten emerging markets by weightings

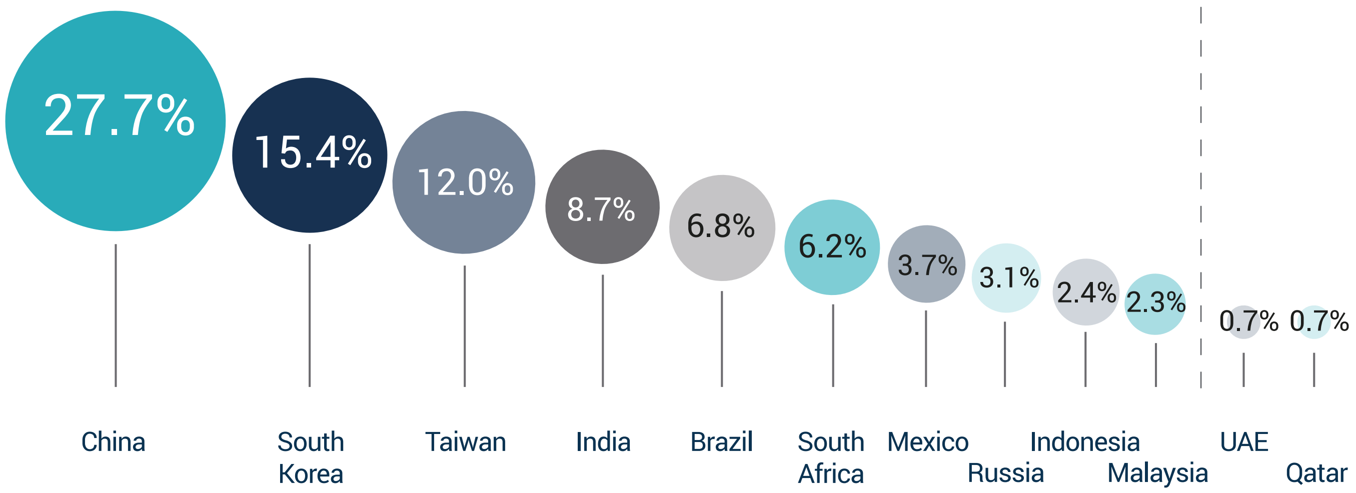


FIGURE 3
Potential Saudi Arabia weighting within the MSCI Emerging Markets Index

The Opportunity:
The potential impact of the change on the investment landscape

Even at a lower weighting though, the positives are substantial. The primary benefit of a promotion into the emerging markets is the immediate inclusion in the coverage structures of global emerging markets funds. Whilst there are less than 100 GCC-focused funds internationally, there are well over 5,000 funds that are dedicated to the emerging markets, at least half of which invest across all emerging markets, i.e. without a particular mandate to invest in certain markets (for instance, the BRIC markets, Asian emerging markets or individual emerging countries).

Amongst this “unrestricted” group of emerging markets specialists, close to $590 billion is invested into emerging markets equities. Over $190 billion of this is held within approximately 300 index funds, and emerging markets index funds generally invest directly in line with country weightings. Therefore, even at the lower end of our initial estimate, this equates to an additional $2.3 billion invested in Saudi Arabian equities, which alone would more than double the current foreign holding and this level would strengthen further as the weighting increases.

This then leaves $420 billion invested by actively-managed global emerging markets funds. It could be asserted that total new investment from these funds will be balanced out to around the weighting benchmark that MSCI sets, but active funds are not pegged to benchmarks and are generally able to invest much more heavily in favoured stocks; conceivably a “top investment pick” from the Tadawul could account for 5% of an active fund’s portfolio. This makes quantifying the opportunity from active funds difficult, but applying our index entry weighting estimate for illustrative purposes, the base case among active emerging markets funds would be around $5 billion of new foreign equity investment into Saudi Arabia.

Yet by far the largest potential inflows into Saudi Arabia could come from globally-focused funds. Even though these lack the specialisation in developing countries, the likes of the Norges Bank-managed Government Pension Fund, which, as Table 2 shows, is both the largest non-specialist investor into the emerging markets and heavily exposed already to Saudi Arabia. Moreover, three of the top four largest funds invested in the emerging markets are globally-focused.

In all, while only one in ten globally-focused funds has exposure to the emerging markets, between them these invest a total of $850 billion into emerging markets equities, with over 85% of this held by actively-managed funds, making this by far the largest capital pool that would potentially be newly accessible to Saudi issuers. Even accounting for the small amount already invested, sizeable inflows from global funds are feasible, based on their current emerging markets investments, with around an additional $3.7 billion essentially guaranteed to be invested in Saudi issuers by global index funds, even at the lower end of the initial range, and a far greater potential from global active funds.

Therefore, in terms of immediate gains, index-tracking funds, both specialist emerging markets and globally-focused, could be expected to quickly reach the weighting level ascribed to Saudi Arabia, wherever that will sit, with the potential scaling up in line as the weighting develops. Two weighting scenarios are depicted in Figure 4 overleaf, which also shows the commensurate level of new active investment on the basis of these funds also investing in line with the benchmark.

TABLE 2
10 largest funds invested in emerging markets

Fund	Country	Emerging markets ($B)	Saudi Arabia ($M)	Focus
Vanguard Emerging Markets Stock Index Fund	US	63.3	0.0	Emerging (Index)
Government Pension Fund	NO	62.8	477.2	Global (Active)
Vanguard Total International Stock Index Fund	US	56.0	0.0	Global (Index)
ABP Global Equity Portfolio	NL	34.9	8.9	Global (Active)
iShares MSCI Emerging Markets ETF	US	27.0	0.0	Emerging (Index)
iShares Core MSCI Emerging Markets ETF	US	25.6	0.0	Emerging (Index)
Oppenheimer Developing Markets Fund	US	25.4	0.0	Emerging (Active)
DFA Emerging Markets Core Equity Portfolio	US	19.0	0.0	Emerging (Index)
DFA Dimensional Emerging Markets Value Fund	US	16.6	0.0	Emerging (Index)
Fidelity Series Emerging Markets Fund	US	14.2	0.0	Emerging (Active)

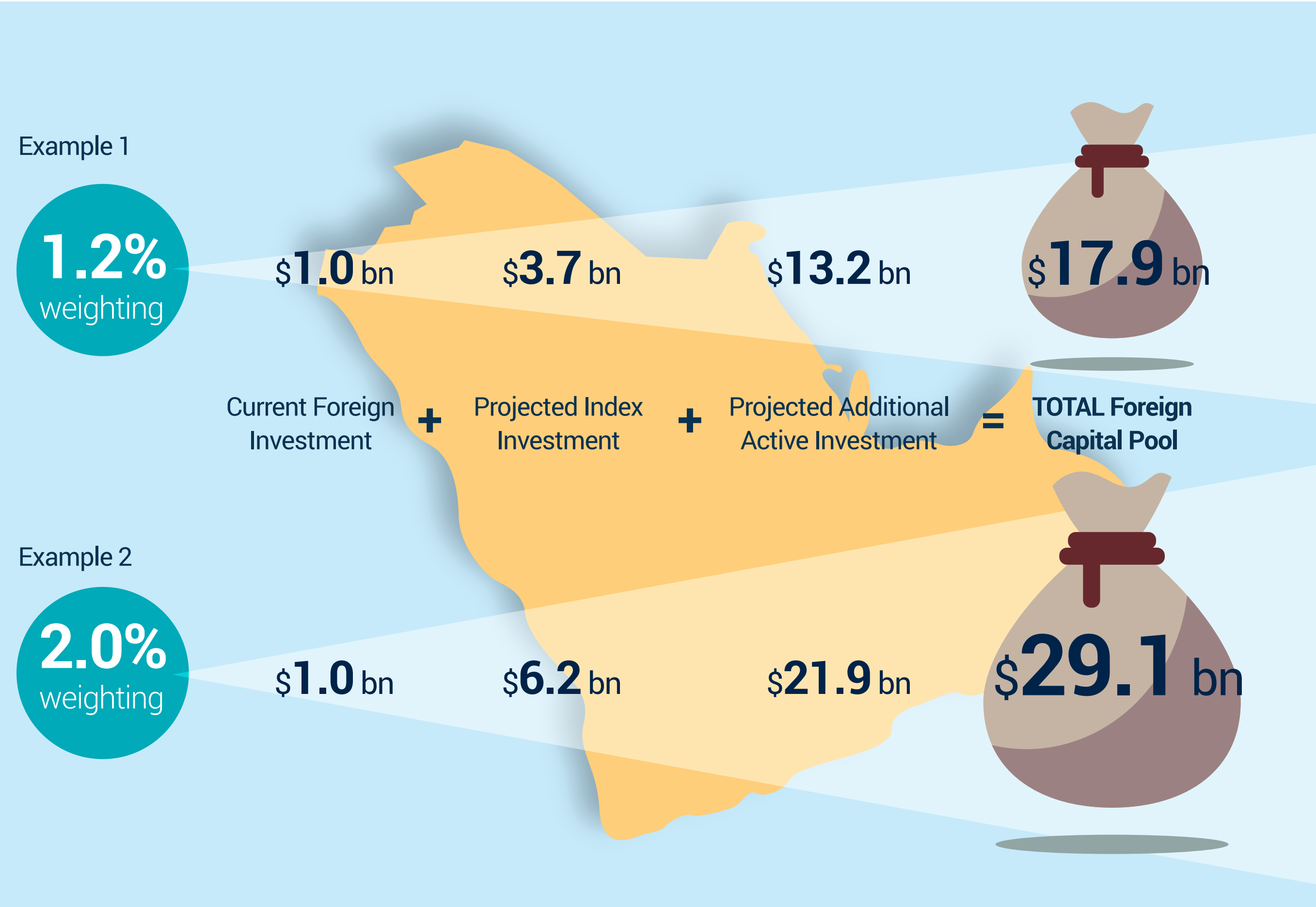
Source: FactSet

TABLE 3
Volume of global investment in emerging markets

EM investment ($ billions)	Global	EM-focused	Total
Active	731	420	1,151
Index	119	194	313
Total	850	614	$1.46 trillion

Source: FactSet. Excludes funds that cannot invest in Saudi Arabia

FIGURE 4
Projected assessment of the opportunity for Saudi Arabia from emerging markets investors



The Threat:
The action and the reaction

MSCI's decision is delayed

The above analyses assume that Saudi Arabia is elevated to the emerging markets index in 2018, an eventuality that is by no means guaranteed. If the decision is delayed, a continuation of the status quo is the worst case scenario, although a knock-on benefit of the MSCI consultation taking place, is that Saudi issuers will already be monitored on the watch-lists of some active funds, raising the prospect of interest in interaction between the funds and the issuers, and making new investments at least conceivable.

The small top-down impact

If the upgrade does occur, the main overall benefit, initially at least, will sit with the largest issuers, and specifically those that are quoted on the index. The 32 stocks that currently constitute the MSCI's Saudi Arabia stand-alone index are the front-runners for potential inclusion in the Emerging Markets Index; with MSCI likely to include a group of issuers covering around 85% of the Tadawul's market cap in the index, they will in turn preclude issuers under a certain size, meaning that the real impact of reclassification would not automatically filter down to the entire market but would be mainly concentrated among the major players.

There would also not be an overnight shift from emerging markets-exposed index funds towards investing into Saudi Arabian equities, as this will depend both on accessibility of shares and the time taken for the index weightings adopted by index-tracking institutions to be recalculated and reapplied. Typically, this can take 3–6 months or longer to ramp up, but as it does this group will provide a stable source of liquidity.

The impact on the remainder of the GCC

Outside of the considerations for Saudi Arabia, the UAE and Qatar would inevitably see their weightings squeezed, considering also the ongoing changes to China's weighting and the emergence of Pakistan within the index following their recent promotion to emerging markets status. We would anticipate the current weighting impact on the UAE and Qatar to be relatively small, pushing their weightings down by 0.01% each, however, the more intangible impact on active fund interest in these markets, with the entrance of the larger Saudi market into the picture, may well be greater.

Equally, the Saudi Arabian upgrade could have positive connotations for investment across the GCC, as active interest will be piqued by the change in classification, and potentially then further sustained by a Saudi Aramco IPO. Either way though, the onus is on issuers throughout the GCC to secure and maintain investor interest through the right levels of interaction.

In whichever scenario, the danger is that the benefits of the growing profile of the GCC among international investors are negated by weak investor relations and disclosure, preventing issuers from maximising the opportunities presented both by improved access for foreign capital and increased visibility in major indices, emerging markets-focused or otherwise.

Key considerations in succeeding in the competition for capital

Overall, the accession of Saudi Arabia to the emerging markets would bring clear positives with a few points of caution, particularly for mid and small cap Saudi issuers and companies in other GCC markets. Universally, however, there would be increased scrutiny on the investor relations practices of Saudi and GCC issuers. As such, a priority for companies is ensuring that the right approach is taken to IR, as a means both to meeting heightened investor expectation around disclosure and transparency, and in turn to optimising the valuation of the stock.

This means paying particular attention to the fundamental tenets of best practice investor relations:

- Clear, detailed and transparent articulation of the equity story and company performance;
- Close monitoring of the market dynamics impact on trading and valuation as Saudi Arabia's status develops;
- A structured strategy towards investor engagement to ensure new opportunities to interact with relevant foreign investors and drive new investment are capitalised on; and
- Ensuring an efficient IR infrastructure that is set up to record all interaction and feedback to apply to future activities.

Those that can best fulfil the IR expectations of the foreign investment audiences will be at a significant advantage when it comes to realising the true benefits of the Saudi Arabian market attaining full emerging markets status. They will ultimately forge the best opportunities to build and sustain investor demand and, while the process will not happen overnight, will be best-placed to tap into the substantial global capital pools.

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