Great expectations

The accession of UAE and Qatar to the MSCI EM index and the prospect of opening of Saudi Arabia's Tadawul is shifting the investor base in the region. *Global Investor/ISF* speaks to seven experts in the region

PARTICIPANTS

Chair: Hugo Cox, Global investor/ISF
Robert Ansari, executive director and head of Middle East, MSCI
Hammad Izz-e-Hamid, securities services, Middle East and Africa, Deutsche Bank
Arindam Das, regional head of securities services, Mena, HSBC
Husayn Shahrur, executive director of Mena Equities at NBK Capital
Ajay Kumar, assistant general manager, asset management, Qatar National Bank
Claus Nouveau-Nikolajsen, managing director, global markets, ADS Securities
Nigel Sillitoe, CEO, Insight Discovery

What happened to equity valuations and inflows following the entry of the United Arab Emirates (UAE) and Qatar into the MSCI Emerging Markets Index?

Robert Ansari: By the time MSCI has made its announcements about the reclassification of the UAE and Qatar, investors were already moving into these markets. By way of context, the amount of money tracking emerging markets now is about $1.5trn and of that approximately 20% is passive, which means that 80% of what was mathematically going to track these markets could have moved before the countries entered the MSCI Emerging Markets Index. Really, the MSCI categorisation of these countries was following investor sentiment rather than leading it.

To gauge how much of the flows will have arrived by the time an index change like this takes place, it is worth just recapping the MSCI methodology. The first step is that MSCI takes feedback from investors around the world – MSCI is then a middle man that provides information back to the regulators and exchanges, which then react to that feedback.

The big misconception is that people think that once those rules are passed then we are good to go, but the reality is that once those rules are passed, what has to happen is investors need to enjoy the benefit of those changes. So, if it is something like delivery versus payment (DVP), investors need to see the impact of a rule change rather than just a rule change. So, by the time we get to the point of announcement a lot of work has already happened. In a way, MSCI's classification is almost a by-product of things that are already happening rather than the cause of things happening.

Hammad Izz-e-Hamid: According to

analyst reports, $1bn to $2bn was likely to come into the markets over the course of one to two years. There is understandably a build-up and a sharp rise in anticipation of the actual inclusion in the index and a correction phase thereafter. In general, we believe that there will be increased flows as the market coverage increases. Macroeconomic fundamentals remain strong and should support stable inflow for institutional funds.

Arindam Das: The inflow has been far higher than analysts expected. Initial expectations were about $1.5bn. In the period May to June, we saw assets in our custody increase by more than $3.5bn. Part of it was market movement, but a lot of it was actual flow. It is difficult to estimate how much of this was contributed by passive funds, but I would think that a substantial amount was through them because active funds had the whole year leading up to this date to rebalance their portfolios and invest in these two markets. Overall we underestimated the amount of passive funds that would come in following the upgrade.

Is the quality of corporate governance in the region improving, especially post-upgrade?

Husayn Shahrur: In the days and months leading to the countries entering the index we saw a lot of passive money coming in. This is not very relevant to improvements in the corporate governance and wider development of these capital markets as this money does not scrutinise companies and does not differentiate between companies with good practices or otherwise. By contrast, the active money, which is supposed to be chasing after good companies or good sectors, has different impact in this regard. As we go along, these countries will register increasingly on the radar of fund managers and institutional investors. Issues of corporate governance will come up more and more and companies that have lax practices will have to adapt and evolve if they are going to attract a wider investor base.

Ansari: This is still a priority. A lot of international asset owners now look for a high level of self-discipline. We now get a lot of fund managers coming to us and saying: "We need to have a stricter level of control or a higher culture of risk [assessment] in our organisations." And there is a shift in those companies from calculating risks using basic tools to products that are recognised by international investors.

Das: Frankly, if you talk to investors and intermediaries they do not yet feel that everything is right. There are still concerns about the settlement infrastructure and there are still concerns about the level of custodian control. So the full quantum of the money that can come in is still not

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invested. If you take asset managers or global custodians in Japan and Korea or in the west, there is still a fair bit of apprehension about the way the markets operate, including the dual account structure and the challenges with the irrevocable rejection process. Part of this is an education process.

We need to better articulate the improvements that have been made to the settlement process in the last few years, but there is still scope for improvement. The reassuring part is that the market authorities are open to feedback and are willing to change.

Ajay Kumar: MSCI classification and the process towards classification has reconfigured the region's markets. The process towards classification helped restructure the settlement mechanism and opened up better foreign participation.

First, it is helping improve governance – companies have begun to realise that sophisticated investors will offer premium to companies with better governance and that will put others under pressure to improve disclosure norms. This benefits the market, as good disclosures will make bad policies difficult to conduct.

Second, the cost of trading comes down. For large fund managers such as us, impact cost is a source of performance drag. With larger foreign investors coming in the impact cost comes down.

Third, these markets had a homogeneous set of investors that resulted in a herd mentality – the classification has brought some heterogeneity in investors, a wider spectrum of investors across liquidity and risk curve.

But this move is not without its risks – investors need to realise the paradigm has changed. The volatility has increased, correlations have shifted. When the global financial crisis took hold you suddenly saw a large amount of foreign institutional money moving out of this region. At this time it was not too much of a problem, fortunately, because foreign institutional investors were still not a very large portion of this market.

Now, going forward, that is going to be different. Investors will need to brace themselves for strong fund flows that may be independent of domestic considerations. Index providers meanwhile need to understand the market better when rebalancing – the recent experiences of both MSCI and S&P is a case in point.

What can investors expect from the prospect of the Saudi Arabian equity market opening to foreign investors next year?

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"Companies have begun to realise that sophisticated investors will offer premium to companies with better governance that will put others under pressure to improve"
AJAY KUMAR, QATAR NATIONAL BANK

Das: When international investors come into this market, I think the biggest challenge they will face is the shift to a short settlement cycle of T+0, which is very different from most developed and even emerging markets. While in China A shares has a somewhat similar settlement cycle – stock on T, cash on T+1 – the sheer size and attractiveness of the China market has drawn many international institutional investors.

However, many others have stayed out and MSCI has not included China A shares in its Emerging Markets Index. Thus a T+0 cycle will pose its own challenges to foreign investors, but will not be a showstopper. The good thing is that we are now going through the consultation phase – although the consultation is more about the draft regulations on qualified foreign investors (QFI) rather than the clearing and settlement model. Practically speaking, I think we will have to start with the current cycle of T+0 and move to a longer settlement cycle as we go along.

Izz-e-Hamid: The opening up of the Tadawul to provide direct access will have a significant impact on the capital markets landscape. We understand that the regulatory authorities in the kingdom have adopted a consultative approach towards opening of the market. The rule of thumb is that this is going to be a gradual and phased process.

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The regulatory authorities are aware of the standards that are in place in the regional markets and those that are in practice internationally. The regulators would not want to disturb the local operating environment too much at the outset, and will ensure stability is maintained as further steps are taken to open the market fully. Foreign portfolio flows, which analysts expect to be in the range of about \$30bn-\$50bn after the market opens, will be closely linked to the addition of Saudi Arabia to the MSCI Index. Given the size and scale of the Saudi Arabian market, it is quite probable that they may make a direct entry to the Emerging Markets Index.

Das: The number doing the rounds is that

there is a potential opportunity of $50bn-plus worth of flows coming into the market in due course, as and when Saudi Arabia is included in the MSCI Emerging Markets Index. However, that will take time – an MSCI review can be initiated only in June 2015 for a decision regarding the upgrade in June 2016, for implementation in June 2017 – and a number of steps need to be taken to have enhanced clearing and settlement procedures, greater custodian control, and avoid prefunding and pre-validation before the market is upgraded.

However, the market opening and liberalisation is always an evolutionary process and we are privileged to have a very responsive regulator and stock exchange in Saudi Arabia – so we have no doubt that solutions will be found to any challenges in hand.

Izz-e-Hamid: The market opening, possible inclusion in indices and increased foreign participation will benefit Saudi Arabia in the same manner that has been observed in other markets. There will be further improvements in corporate governance and the systemic infrastructure, elements that are of particular importance to foreign institutional investors.

The opening up of the market and the QFI regime shall bring to the fore the importance of the custodian function. The introduction of the independent custody model (ICM) will be another significant development that will embed the role of a specialist custodian. With time there will be a wider array of tradable instruments and the introduction of a depository receipts, which are something that has been under consideration.

Shahrur: In my opinion, expectations will be shaped by the reaction of local investors ahead of the actual implementation of the new regulations next year. We have already seen a sharp rally. If this is maintained, then this will eat greatly into the case for Saudi Arabia from a valuation perspective, though fundamentally this will remain a high growth, very solid market. If the rally subsides, then foreign investors will have more space to participate in some of the strength and diversification potential offered by the market.

Sillitoe: The other point is access of asset management companies. I think the Capital Market Authority (CMA) will have to set up some sort of education programme to make it easier for external investors.

A lot of our research is showing that for international asset management companies the big topic now is obviously Saudi Arabia – not just about trying to access the capital markets but obviously to look at how you can raise capital to use there. But obviously that often now involves having to have the relevant licence or partnership with a CMA licensed business.

Then there is the practical point about visits – the Saudi Arabian government will have to look at easing the rules for visas because if you are a fund management company from New York hoping to analyse some of these companies, the current process is very difficult.

What does Saudi Arabia offer that investors cannot get elsewhere in the region?

Shahrur: The size and prospects of Saudi Arabia's consumer sector are very good. There is a big investment theme regionally around domestic consumer demand, but there are a very limited number of liquid companies in this sector elsewhere in the region – maybe around 10 names. So if you want to gain exposure to that sector, you can almost strictly achieve that in Saudi Arabia where you have a good number of listed companies that are liquid. Also, apart from its fundamentals, this sector exhibits a lower correlation with international markets than other big sectors in the region.

So, for someone sitting in New York, petrochemical companies may be interesting but they are highly correlated with international markets. But for a food business in Saudi Arabia for example, the low correlation means you can diversify your risk while giving you a good exposure to a growing regional sector.

What are the prospects for the initial public offering (IPO) market in the region?

Claus Nouveau-Nikolajsen: From the merchant banking side, we definitely see a trend where some of the typical family offices in the UAE are maturing and looking to list. We have perhaps 14 or 15 offices that are considering this currently. This all means that they are opening up and considering in more detail the governance they need to be able to warehouse inside the group and the family for a listing to work. I think the first family IPO that is going to be interesting is this year's launch due to happen out of Dubai Al Habtoor.

From a UAE point of view, this is a key move because it will open up the doors for many others. It was a shame there was a slight delay in the process earlier this year – I think it created some negative impact on some other families that were trying to follow on and IPO themselves. Then you have the whole institutional side of the market. Here there is a long waiting list for companies, with structures to go IPO and this is certainly good from a global investment point of view.

The danger is that if there are set backs – such as the one we have seen this year – the result can be a lot of concern for those waiting to IPO. I think there needs to be a big emphasis on education about what happens when firms IPO – you can change shareholder structures, you can buy out, you can sell out, but you have to do it in the proper way.

"The size and prospects of Saudi Arabia's consumer sector are very good"
HUSAYN SHAHRUR, NBK CAPITAL

Ansari: I think Claus [Nouveau-Nikolajsen] has a good point when he focuses on education and it is relevant to the range of structures that can be offered. The point is that the predominant type of investor in this region is the retail investor. In Saudi Arabia the retail investor is approximately 95% of the market. They have two types of asset to invest in basically – real estate and equities. Before investors look at new types of products and investment vehicles

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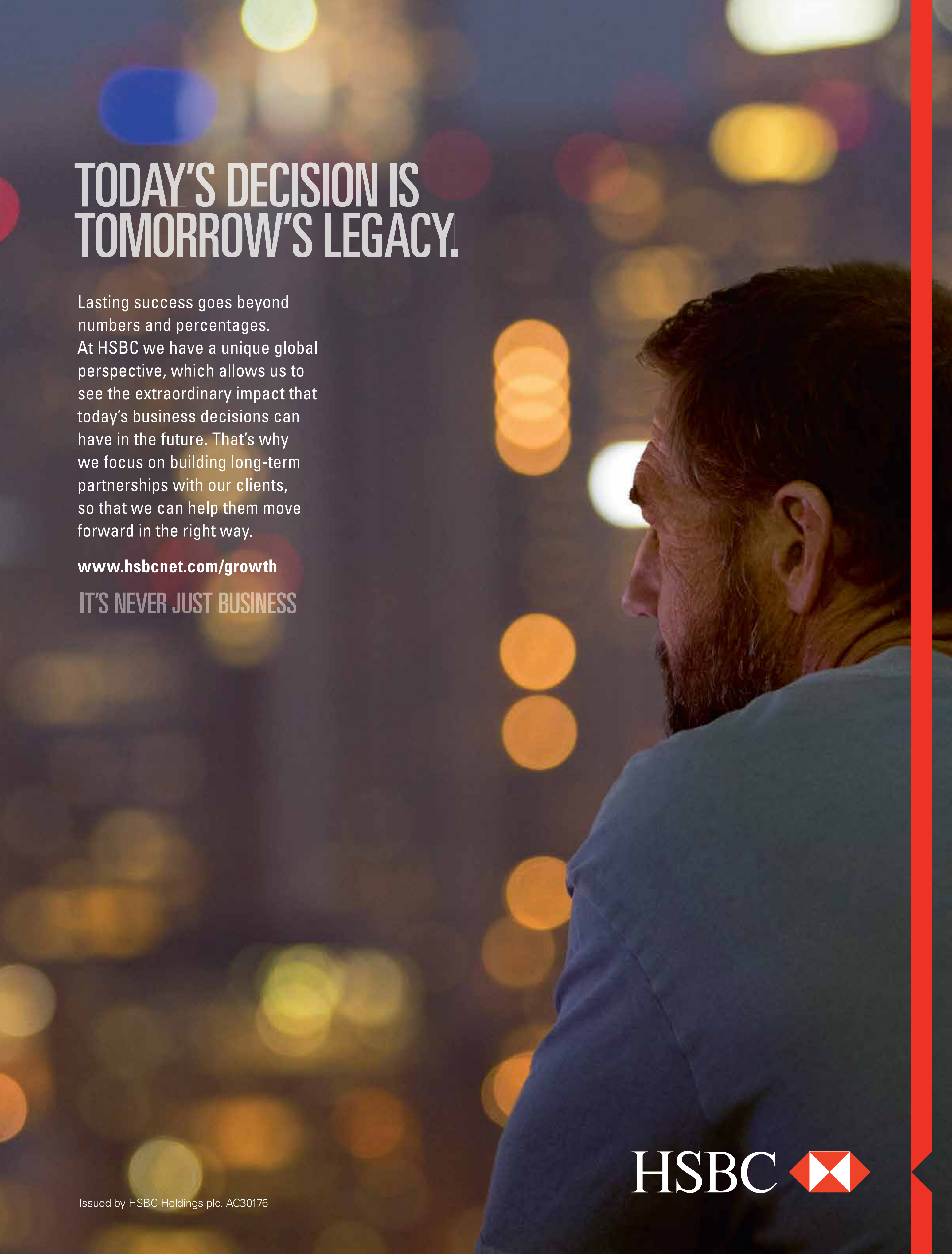
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they need to understand the benefits of these alternative routes to get exposure.

Shahrur: At the origin of this is that a number of the IPOs in the region are government assets, and are done with the intention to redistribute these assets or wealth to the public. Also, many of these companies fall within subsidised industries with lower energy and feedstock costs, like the case for the petrochemicals and cement sectors in Saudi Arabia. So, one way to have everybody benefiting from the subsidy is to intentionally offer the IPO to nationals at a price significantly below the theoretical fair price. We have seen these IPOs usually rally by 100% on the day of issuance.

By contrast, a family business that is not benefiting from any subsidy finds it hard to compete with the steep discounts offered by these IPOs in order to attract potential investors. A related factor that prevents these families from listing is that they are not clear what options exist regarding what they can do with the money they will potentially raise. Also, a lack of integrated regional markets impedes cross-border investment and limits investment opportunities. For example, a UAE company that wants to grow to other markets within the region – not even globally – faces so many obstacles.

Moreover, regulations in some markets are quite inhibitive – the Dubai Financial Market (DFM) comes to mind in this respect. Similarly, private equity funds, for reasons largely related to pricing and regulation, have shied away from IPO exits.

Kumar: With valuations and liquidity where they are, it is probably the ideal time to IPO now. When you look at Qatar, the government has announced IPOs of about $50bn over the next five years, it is about $10bn per year, and for a market of this size it looks very attractive and useful.

The problem with IPOs that are part of a government unbundling of assets is that it is saddled with restrictions that prevent fair price and symmetry. It is fair for governments to unbundle assets to its citizens at a discount, it is both good and desirable, however after it is listed it should be allowed to be freely traded so that its true value may be realised and the benefit of listing is enjoyed by all the stakeholders in the capital market.

When it comes to the family houses, I agree with the argument that the governance is bad and that is one of the reasons holding it back. There has not been much success in terms of the free float these companies have enjoyed since listing. The second factor is that most family houses business are floated as conglomerates that have five or 10 different kinds of businesses in them.

When you put a lot of small businesses all bundled up together this way and then offered, there is no business model per se that investors can look at. It is hard to be confident of the management's capability to oversee 10 different businesses given its governance track record.

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ARINDAM DAS, HSBC

How do you evaluate the political risk of investing in the Middle East? Has the importance to investors of political risk changed?

Das: This region is no stranger to political turbulence – sometimes there is more of it, sometimes there is less. The problems recently in Iran and Syria have not hit the markets in UAE or Qatar as much as they might have done. The focus this time has been on issues directly affecting the specific country being traded, not necessarily around what happens around the periphery. And the Middle East is not the only place with political risk – just look at the European situation or what is happening in Ukraine. We are not living in an oasis of calm.

Kumar: Politics will become more important as foreign investor stakes in these markets increase. The perception of risk in, say, Qatar is different I think for a fund manager sitting in New York several thousand miles away from a domestic institution. He is probably more sensitive to it – if the market is largely domestic, which is the case for Saudi Arabia or Qatar, the risk is probably not considered as high as when foreign investors become a dominant force in the market.

Does a Dubai-Abu Dhabi Bourse merger make sense?

Ansari: There have been comments in the press about combining the back offices of the Abu Dhabi Exchange and the DFM, with the front offices still functioning separately. When the outside world looks at the UAE it do not necessarily appreciate that there are two distinct exchanges and if it does not necessarily impact international investor habits with the respect to

the market one could argue to keep them as they are.

Claus: A certain amount of liquidity needs to come back to the market, and the merger between the two exchanges would facilitate that. I see it as part of this wider theme of market maturity. There is much more these exchanges can bring to the market and I think they should start being more open about how they are working.

Izz-e-Hamid: The merger of the two exchanges may be an important development in itself. However, what is perhaps more pressing in terms of need is the harmonisation of practices and procedures at an operating level. Standardisation, – for example, across administrative tasks such as investor registration – may ease of market entry to foreign investors and avoid the duplication of efforts. Further, alignment of the framework for regulations and settlement processes may bode well for all market participants. In terms of our working experience, the regulatory authorities are mindful of the reforms that will bring about synergies and add scalability, aimed to make it easier for investors and intermediaries to operate across the markets.

Qatar has said it needs $220bn of investment for the World Cup. Are investors keen to provide it and will they be adequately rewarded for the risk they take on?

Claus: Qatar does need quite a lot of capital. The government commitments will ultimately be more than sufficient to meet it but there will be some private sector participation. However, when you look at the question of whether investors are actually being rewarded for taking on this risk I think the general point is no. The UAE, which is probably the largest borrower in the region, has seen its spreads narrow from 500bps [over treasuries] to around 150bps. Absolute rates, at about 4%, are the lowest since 1960.

So when you look at all this you have to say that now you have so much liquidity being pumped into the market and spread figures that are consistently dipping over the years. So, no, I do not believe that investors have been adequately rewarded for the risk they are taking on.

Is participation by foreign asset managers in the Middle East increasing?

Sillitoe: International asset management companies are interested in the region and particularly in UAE. One question frequently asked is: "Which is the financial centre of the Middle East. Dubai? Abu Dhabi? Bahrain? Saudi Arabia?" In Dubai, I am still staggered by how many companies are either setting up here for the first time or are expanding their operations. If you look at every global asset management company that is physically in the GCC region, there are only five that are not represented in Dubai. That is quite a staggering statistic.

It is also worth bearing in mind that every GCC jurisdiction has a slightly different appeal to businesses and that each jurisdiction itself has different priorities about what the type of business and investment it is looking to attract. In Qatar, for example, the government is providing a regulatory framework and incentives to hedge fund managers to set up there. Qatar is also the only regulatory authority which has so far introduced mandatory commission disclosure by retail financial intermediaries.

Across the region we are seeing positive signs that regulatory standards are being raised. Lessons are being learned from current regulation and legislation in what might be perceived as more mature markets of the US, Australia and Europe. As the financial markets of the Middle East develop, individual governments are making it clear that they will not be left behind when it comes to good governance processes.