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MARKET COMMENTARY

Ashmore

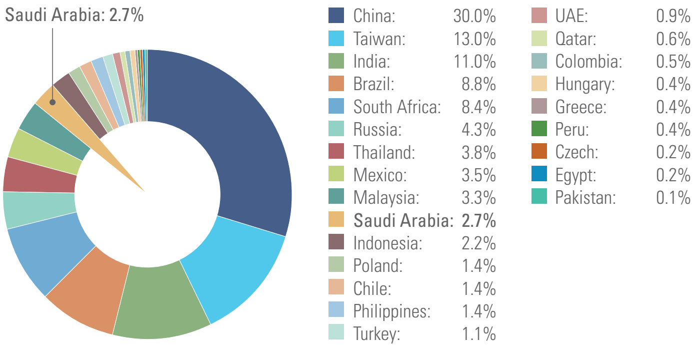
Saudi Arabia's Big Year: 2019 index inclusion

By Edward Evans

It was announced on 28 March that Saudi Arabia will be a constituent of the FTSE Emerging Markets index. The inclusion will take place in five tranches between March 2019 and December 2019 and the market is expected to be approximately 2.7% of the index. On current prices this would make Saudi Arabia's stock market the tenth largest market in Emerging Markets (EM). The decision was taken by FTSE after a number of improvements were undertaken by Saudi Arabia resulting in significant liberalisation of the capital markets.

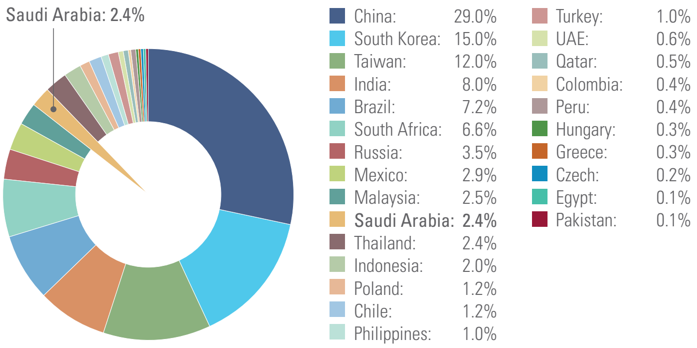
The inclusion of Saudi Arabia in the FTSE Emerging Markets index paves the way for MSCI's decision whether to include Saudi Arabia into its index. The decision is expected at their June review. Saudi Arabia would become approximately 2.4% of the MSCI Emerging Markets index, if included, and the index would cover around 32 companies. Based on its consultations with investors so far, MSCI has indicated that inclusion could take place in two tranches over the course of 2019.

Fig 1: **FTSE Emerging Markets index including Saudi Arabia, estimate**



Source: Ashmore. Estimation as at 31 March 2018 country weights.

Fig 2: **MSCI Emerging Markets index including Saudi Arabia**



Source: Ashmore. Estimation as at 31 March 2018 country weights.

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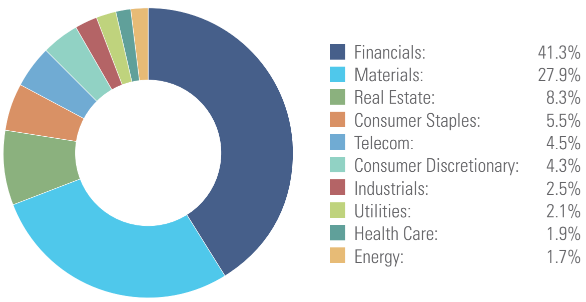
The Tadawul market

The local market, the Tadawul All Share index, has a market cap of USD 499bn (similar to Mexico and Malaysia) and an average daily trading value of around USD 1bn (similar to South Africa). The Saudi Arabian market is majority owned by local institutions, with foreign ownership modest at approximately 1.8%. This compares to 9% for Qatar and 12% for the UAE. Meanwhile, local individuals, at over 85%, dominate trading volumes.

The market is relatively diverse with representation from all sectors, although financials, at around 41%, and Materials, at around 28%, are the largest.

Fig 3: **Tadawul All Share index sector composition**



Source: Ashmore. Data from Bloomberg, as at 5 April 2018.

Future Initial Public Offerings (IPOs), including potentially Saudi Aramco, could enlarge the size of the market materially. FTSE assume a mid-range value for Aramco at USD 1.5tn and an initial public float of 5%. This would result in a free float market cap of USD 75bn and resultant index weight of Saudi Aramco of 1.4% in the FTSE Emerging Markets index. This would increase the current estimated country size of 2.7% in the index to 4.1%. We await further clarity around the timing and size of any potential listing of the oil giant.

Continued overleaf

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Economic backdrop[1]

Saudi Arabia boasts the attractive dual attributes of a large population, of 32 million, together with a high GDP per capita of USD 20,000. The economy is the 20th largest in the world with a GDP of USD 684bn. FX reserves are significant at USD 487bn and the peg with the US dollar reduces currency risk. However, the economy currently revolves around energy. Oil represents around 74% of exports and 63% of budget reserves.

Vision 2030

Crown Prince Mohammed bin Salman's 2030 Vision for the development of Saudi Arabia's economy centres around diversifying the country's income sources beyond energy. As part of these efforts the Kingdom is opening up to overseas investors. The authorities have been quick to implement international standards of market practice and operations. This included the simplification of the Qualified Foreign Investors (QFI) process, the introduction of T+2 settlement cycle, delivery versus payment as well as securities lending and short selling.

Reforms are also taking place across the labour market, the energy sector and the tax structure. In the case of labour, the government is investing in education and training to better prepare the workforce with the skills required for the private sector. This is in recognition that fiscal adjustment will reduce opportunities in the public sector and a sustainable diversification of the growth model requires a stronger role from the private sector.

In the energy sector, we have already seen steps towards the removal of electricity and water subsidies. The tax structure has been enhanced with the introduction of Value Added Tax (VAT) on goods and services and levies on ex-patriate workers. The authorities are seeking to balance the budget, while at the same time supporting economic growth. The programme of gradual fiscal consolidation, of which the toughest part is now completed, should see the public finances improve by 8% of GDP by 2023.

Saudi Arabia offers significant investment opportunities, including considerable low hanging fruit

Bold leadership

Crown Prince Mohammad bin Salman is in a strong position to implement the challenging reform program. We expect the Crown Prince's position to strengthen further over time accompanied by increasing transparency and efficiency in policy implementation. Over the short term, occasional bouts of market volatility are possible given the many interests vested in maintaining status quo.

Significant investment opportunities

Saudi Arabia offers significant investment opportunities, including considerable low hanging fruit. Privatisation is a key element in the reform program, which should significantly expand the number of investment opportunities in the Kingdom. The Tadawul All Share index currently has 179 stocks and it is estimated this could increase to around 250 over time. The inclusion of Saudi Arabia in global indices, especially at a significant weight, will already attract global investors. Saudi Aramco's listing, should it take place, would also put the global spotlight on the local market. Social change, such as the inclusion of Saudi female nationals into the workforce, allowing women to drive and opening cinemas also have potential to release pent-up demand as well as supporting new investment and consumption trends.

Active management will be key. A great deal of the austerity program has now been completed which bodes well for growth going forward. However, in the short term reforms will inevitably be disruptive and potentially weigh on consumption and investment. Selecting the winners of the transformation changes underway should be a particularly rewarding investment over time.

[1] Source: World Bank, Haver Analytics and Morgan Stanley.

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