ADCB بنك أبوظبي التجاري

Catalyst for Saudi equities on the horizon

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- **On June 20 MSCI will announce the outcome of its market reclassification review**
- **Market participants will find out if Chinese A-shares will be added to the Emerging Markets (EM) equity benchmark and if Argentina will be upgraded to EM status (from Frontier currently)**
- **However, for regional investors the focus will be on Saudi Arabia, which has a good chance of getting added to MSCI's watch list for potential inclusion into the EM index in June 2018, with actual implementation a year later (this follows the standard MSCI review cycle)**
- **Should Saudi equities not make it onto the watch list during this review, it is possible an off-cycle announcement will still see the market added later this year**
- **Estimates as to the weight Saudi would occupy in the EM benchmark are around 2%-3% (excluding Aramco) but rise as high as 7% including Aramco**
- **Based on an estimated c$350bn of passively managed money tracking the MSCI EM index, a weight of 2% should result in c$7bn of inflows from passive fund rebalancing alone**
- **Inflows from active funds could be far greater still**
- **The experiences of other equity markets which were upgraded or included into the MSCI EM index suggests Saudi equities could be primed for a period of outperformance**

Saudi equities stand a could chance of entering MSCI watch list - Announcement 20 June

Saudi Arabian equities are currently a standalone index, meaning that they are not included in any of the MSCI's 3 main benchmarks, Frontier Markets, Emerging Markets or Developed Markets. Should Saudi equities be included into one of these benchmarks, it is likely they will bypass the Frontier index completely and go straight into the EM index.

MSCI classification criteria

Criteria	Frontier	Emerging	Developed
A Economic Development			
A.1 Sustainability of economic development	No requirement	No requirement	Country GNI per capita 25% above the World Bank high income threshold* for 3 consecutive years
B Size and Liquidity Requirements			
B.1 Number of companies meeting the following Standard Index criteria	2	3	5
Company size (full market cap)**	$635m	$1269m	$2538m
Security size (float market cap)**	$47m	$635m	$1269m
Security liquidity	2.5% ATVR	15% ATVR	20% ATVR
C Market Accessibility Criteria			
C.1 Openness to foreign ownership	At least some	Significant	Very high
C.2 Ease of capital inflows / outflows	At least some	Significant	Very high
C.3 Efficiency of operational framework	Modest	Good and tested	Very high
C.4 Competitive landscape	High	High	Unrestricted
C.5 Stability of the institutional framework	Modest	Modest	Very high

Source: ADCB, Thomson Reuters

To determine an equity market's classification, MSCI follows a methodology which focuses on 3 key criteria (see table above), these are: 1. Economic, 2. Size and liquidity requirements and 3. Market accessibility (foreign ownership levels, free flow of capital, etc). In terms of the economic criteria, this is only relevant for markets seeking developed market status, and are thus not an impediment for Saudi inclusion into EM. In terms of size and liquidity requirements, Saudi equities also qualify for EM status, comfortably exceeding the required 3 companies meeting the above thresholds. The potential inclusion for review therefore hinges on the market accessibility criteria, an area where the Saudi Capital Markets Authority (CMA) and Tadawul stock exchange have been making significant progress over the past 12 months. Specifically, moving the T+0 settlement cycle to T+2, allowing short-selling, easing qualified foreign investors (QFI) criteria and increasing foreign ownership limits. These efforts were publicly recognized by MSCI in January; saying that "*it welcomes the recent positive market reforms undertaken by the Saudi Arabian Capital Market Authority and the Saudi Stock Exchange. These reforms should make a significant contribution toward bringing the Saudi equity market closer to Emerging Market accessibility standards*" **(link to full press release)**.

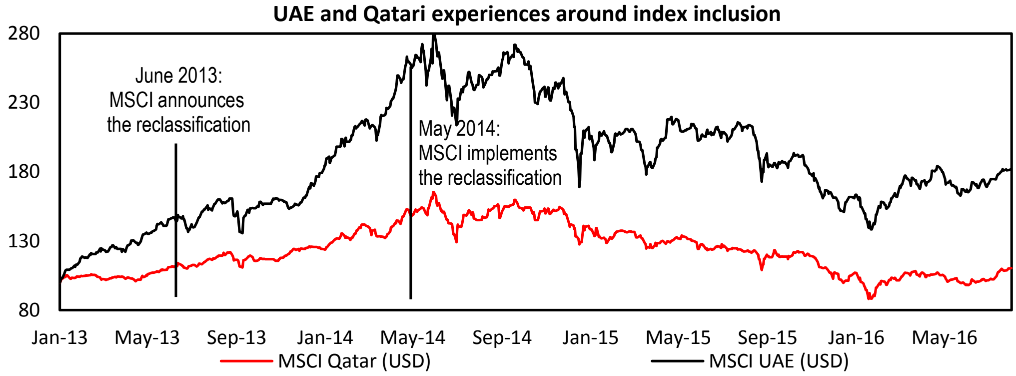
Market reforms part of larger structural reforms

Although the cyclical driver of the economy remains the oil price, any structural reforms the country is able to implement will improve its long-term outlook. These financial market reforms are part of a broader set of structural reforms the Kingdom is undertaking in its bid to diversify away from its oil dependency **(a theme we have written on)**. Saudi Arabia's Vision 2030 outlines the Kingdom's social, economic and development objectives over the coming 13 years. Enhanced private sector involvement as well as a more business friendly environment should support diversification prospects for the economy. The sectors which will benefit most from these initiatives are the non-oil sectors of the economy. In particular banks, real estate and tourism. Of course, these reforms will take a long time to enact and for the country to see the benefits. Further fiscal consolidation will need to happen during the transition period which will weigh on growth and earnings. International investor skepticism as to the Kingdom's ability to transition its economy is high, suggesting that very little is priced into the market on this front.

Markets which get upgraded, tend to rally ahead of time

UAE and Qatari equities were formally added to the MSCI EM index in May 2014. Prior to this, both markets performed very well in the run-up to their inclusion, the MSCI UAE index rose 92% between June 2013 and May 2014, while Qatari equities rallied 48%. Essentially, investors speculate as to which markets will be upgraded by MSCI while fund managers will also re-position ahead of time. It is worth noting that both the UAE and Qatari markets were on the watch list for circa 5 years before they were upgraded to EM status (from Frontier). However, this period included the global financial crisis which inevitably delayed inclusion. We are more optimistic that given the pace of financial market reforms in Saudi currently, that the duration Saudi will spend on MSCI's watch list will be much shorter.

UAE and Qatari experiences around index inclusion



Source: Thomson Reuters

Conclusion

The MSCI announcement on June 20 will be closely watched by regional and EM investors alike as to some key upgrades/inclusions, not least that of Saudi Arabia on to the MSCI watch list. Should Saudi make it onto the watch list, MSCI will conduct consultations with market participants and announce a potential inclusion (or not) in June 2018 with a view of being formally added to the MSCI EM index in May 2019. The potential weight of Saudi equities in the EM index (2%-3% excluding Aramco) will make the market a respectable chunk of the EM benchmark, in line with markets such as Indonesia and Thailand (and double that of Turkey). Skepticism towards Saudi reforms from international investors remains high, suggesting that little is priced in. Although formidable challenges remain in terms of the Kingdom's long-term plans to diversify away from oil, in the near-to-medium term, potential MSCI EM index inclusion should count more heavily than these long-term economic challenges in the minds of investors. Indeed, MSCI inclusion would go some way in validating the direction of travel for Saudi Arabia and should act as a catalyst for further reforms.

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Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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