Event Update - FTSE Annual Country Classification Review

September-2017

Kuwait makes it to Secondary Emerging Market, Saudi Arabia up for an early review...

Index compiler FTSE Russell announced the inclusion of Kuwait to its Secondary Emerging Market Index starting from September-18, following rigorous attempt by Kuwait CMA in modernizing and upgrading the exchange infrastructure and rules, especially over the past year. The decision on Saudi Arabia was deferred and the assessment process was brought forward to March 2018, keeping in mind the progress that the Kingdom made to its processes.

For Kuwait, the introduction of T+2/T+3 clearing and settlement cycle was the only outstanding criteria that was met when the CMA introduced T+3 settlement cycle with a Delivery versus Payment (DvP) model in May 2017 after this was highlighted in the March assessment. *Kuwait has made several changes to its trading system in the past two years, especially the transformation to Boursa Kuwait. Trading activity on the exchange is also hovering at almost 3-year high levels, enabling the regulator to lure regional and international investors to invest in Kuwaiti stocks highlighting liquidity levels. Kuwait also plans to introduce a new equities benchmark next year after completing a reorganization of its listed companies into new market categories.*

Saudi Arabia's deferment of the upgrade comes after FTSE said it needs more time to test the recently introduced changes by the Saudi CMA. *Nevertheless, FTSE had a positive view on the pace of recent market reforms and expressed hope that Saudi will meet the requirements for the inclusion as a Secondary Emerging Market from early 2018 after it makes enhancements to the Independent Custody Model (ICM) as scheduled by the regulator. Saudi Arabia has also made a number of upgrades recently, including being the first market in the region to introduce short selling in order to enhance the depth of the market with sophisticated products and attract foreign institutional investors.*

Today's FTSE review comes as a big boost to regional markets, and although Saudi Arabia was not included, the assertive statement made by FTSE indicates positive results in the next review. *This should lead to additional flow of passive funds in Saudi Arabia and Kuwait, estimated at close to USD 5 Bn for the two markets.*

Criterias for Secondary EM Status	Kuwait	Saudi Arabia
Market and Regulatory Environment		
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	Pass	Pass
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	Pass	Pass
Custody and Settlement		
Settlement - Rare incidence of failed trades	Pass	**Restricted**
Custody-Sufficient competition to ensure high quality custodian services	Pass	Pass
Clearing & Settlement - T+2 / T+ 3	T+3	T+2
Dealing Landscape		
Brokerage - Sufficient competition to ensure high quality broker services	Pass	Pass
Liquidity - Sufficient broad market liquidity to support sizeable global investment	Pass	Pass
Transaction costs - implicit and explicit costs to be reasonable and competitive	Pass	Pass
Transparency - market depth information / visibility and timely trade reporting process	Pass	Pass

Source: FTSE, KAMCO Research

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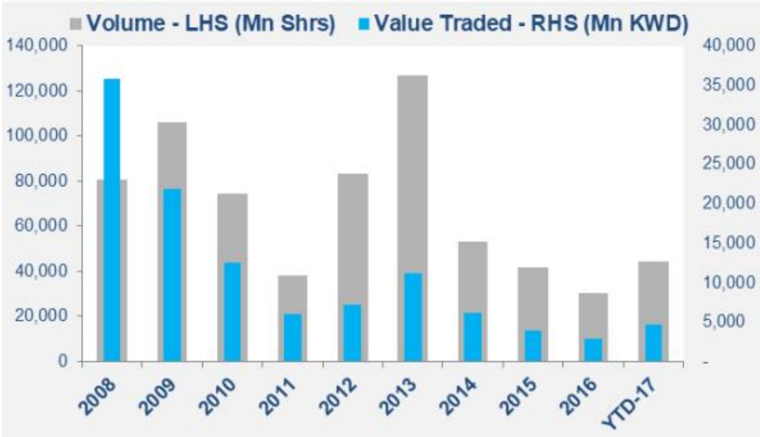
Sets precedence for an MSCI upgrade...

Although the criteria set by the two international index compilers, FTSE and MSCI, vary and are rarely linked, the upgrade by FTSE increases the chances of Kuwait being upgraded to MSCI's emerging market status. We can conveniently presume the same in relation to Saudi Arabia, with investors expected to start accumulating possible large-cap stocks. Moreover, any inclusion in the MSCI Emerging market index for both Kuwait and Saudi Arabia is at least two years away in 2019.

Liquidity remains high in Kuwait...

Trading activity on Boursa Kuwait has already surpassed the level seen in the past two years and it could be on its way to beat the level seen in 2014. The improvement in liquidity in Kuwait comes especially after three consecutive years of decline in the indices and trading activity wherein Kuwait has largely remained underweight for regional fund managers. The YTD-17 returns for Kuwait continues to remain the highest in the GCC with the FTSE upgrade being one of the key factors for investors to accumulate stocks. In addition, since the overall trading in the GCC markets continues to more retail driven, the recent upgrades to the infrastructure, reforms as well as the inclusion of newer products in both Kuwait and Saudi Arabia are primarily aimed at foreign institutional investors that would ultimately result in a more institutional driven market. This was also seen in a Reuters poll which indicated one of the highest allocation to Kuwait by Middle East funds.

Kuwait - Trading Activity



Source: Kuwait Stock Exchange, KAMCO Research

On the other hand, the Saudi market has seen a steep drop in liquidity in 2017 and has been declining since 2014, especially after the fall in oil prices. The total value of shares traded on Tadawul has dropped from USD 308.5 Bn in 2016 to USD 160 Bn for the first nine months of 2017.

Saudi remains on track but needs to demonstrate the reforms before the ugrade…

FTSE acknowledged and was positive on the reforms carried out by Saudi authorities including the simplification of the qualified foreign investor (QFI) registration process and the introduction of a T+2 settlement cycle with a Delivery versus Payment (DvP) model in April 2017. In the review process, FTSE Russell Country Classification Advisory Committee made changes to six criteria . The committee also expects that Saudi Arabia will meet the requirements for inclusion in the index in early 2018 and announced the launch of stand-alone Saudi Arabia country indices and global and regional Saudi Arabia inclusion indexes to assist domestic and international investors who wish to seek early index-based exposure to the market. Nevertheless, it said that the changes to the market structure made by Saudi Arabia and the reforms needs to be tested to make it ready for index users.

Fund flows after an upgrade…

For the Kuwaiti market, consensus estimates suggest average passive investment flows of around USD 700 Mn with a most likely weight of 0.5% in the FTSE Secondary Emerging Market Index. However, the inclusion is expected to be in two steps each with a weight of 0.25% reaching 0.5% by 2019, as seen in previous cases for other countries. On the other hand, due to the size of the Saudi Market, the Kingdom's weight is estimated to be more than 2.5% in the index. This weight is expected to almost double after the anticipated IPO of Aramco. At 2.5%, minimum fund flows are estimated to be around USD 3 Bn going all the way up to USD 6.5 Bn by some estimates after the Aramco IPO.

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