

SAUDI ARABIA POISED FOR UPGRADE TO EMERGING MARKETS STATUS

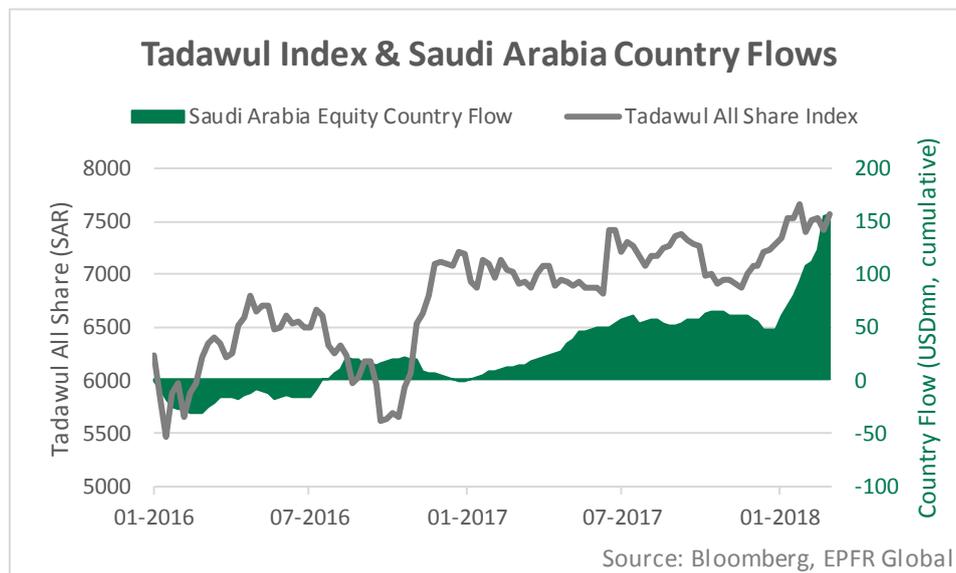
15th March 2018

Fund flows into Saudi Arabian stocks jump in 2018 as investors bet on official Emerging Market Status

Data from EPFR shows that interest in Saudi Arabian equities has really picked up in 2018, whilst the country's benchmark Tadawul All-Share Index has surged 7.5%. This has primarily been driven by three factors:

- The expected inclusion of Saudi Arabian stocks into the FTSE Russell EM Index in March and then the larger MSCI EM Index in June.
- Planned SOE privatisations, which includes the potential USD2tn IPO of Saudi Aramco. The Saudi government plans to increase the number of companies listed on its stock market by nearly 50%, from 170 to 250 companies over the next four years, with an 80-strong IPO pipeline.
- The ambitious Saudi 2030 vision (first announced in 2016) that looks to open up the country's capital markets and reduce the country's oil dependence, which supports the longer-term investment case for the Kingdom. This was needed after a plunge in crude prices crippled the nation's finances.

This is all underpinned by the reform efforts being driven by Crown Prince Mohammed bin Salman (MBS) who, since taking charge of the Kingdom in June, has implemented several economic and social reforms and cracked down on corruption. Thus, as the graph below shows, investors have been piling into Saudi Arabian stocks, with cumulative YTD inflows topping USD100mn.



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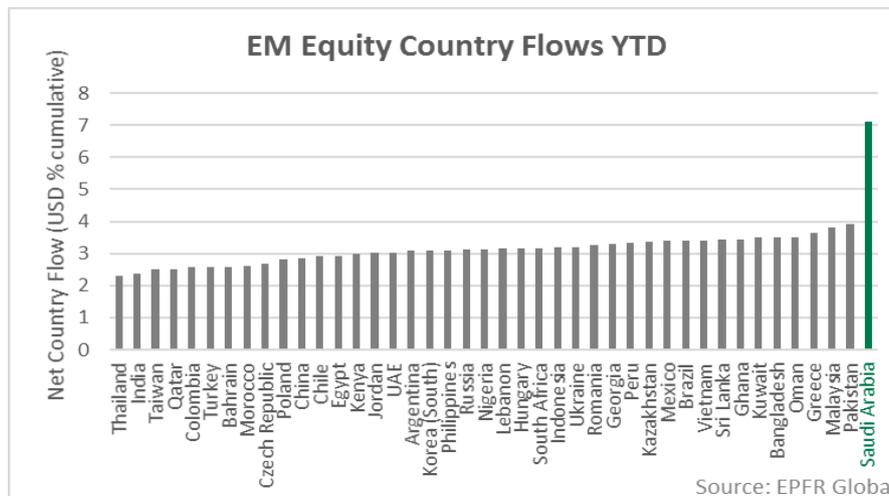
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In percentage terms, equity funds with a mandate to invest in Saudi Arabia are witnessing the highest inflow relative to NAV (Net Asset Value) of all EPFR-tracked emerging markets YTD. These funds have seen net inflows equivalent to 7% of their total net assets YTD - far above its peers which have recorded net inflows of between 2% and 4% (see chart below).



This shows that a number of players have been busy estimating the impact that the factors noted above could have, especially EM index inclusion given the growing role of index tracking funds in EM. Saudi Arabian stocks seem to be following the usual trend of strong inflows up to 12 months ahead of index inclusion.

FTSE Russell EM Index inclusion – possible weight and passive flow estimates

On March 28, FTSE will announce its decision on whether or not it will include Saudi Arabian stocks in its EM Index. The index provider denied the nation entry to its emerging market list in September but said the Kingdom will soon meet criteria to be promoted from unclassified status to a secondary emerging market in March.

- Assuming an initial 2.5% index weight, passive investors are estimated to have to allocated between USD2.5-4.4bn into Saudi stocks.

MSCI EM Index inclusion – possible weight and passive flow estimates

In June 2017, MSCI added the Kingdom to its watch list to potentially be added to its emerging markets index, and as Pakistan's upgrade to emerging-market status in May 2017 came after just one year on the watch list, most anticipate that Saudi Arabia could follow a similar fast pace of inclusion. An announcement is expected June 2018, with effective index implementation starting in May 2019.

- Based on an initial 2.3% weighting, passive investors are expected to allocate USD30-40bn of fresh funds to Saudi stocks.

Impact of Saudi Aramco IPO

Saudi's inclusion in the index could be a key criterion for a successful initial public offering of state-owned Saudi Aramco oil company.

It is thought that the Saudi Aramco IPO could push Saudi Arabia's weighting in the above indices to 5%. This would push Saudi's representation in the index to be comparable with other major emerging-market countries in the index such as India (8.4%) or Brazil (7.3%).

However, the IPO has reportedly been delayed until 2019 as USD2tn valuation desired by Crown Prince Mohammed bin Salman is being questioned by investors.

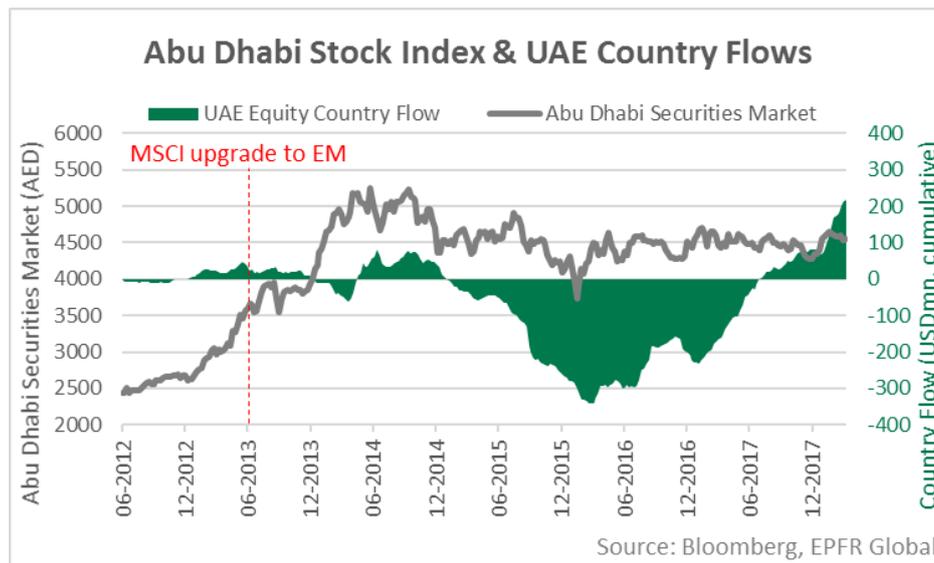
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Previous upgrades to EM status – the cases of UAE, Pakistan and Kuwait.

Like most emerging market upgrades, equity markets in the United Arab Emirates, Pakistan (both MSCI) and Kuwait (FTSE Russell) saw an uptick in foreign asset flows in the preceding 12-month period to their gaining official emerging market status, and we believe the same could happen for Saudi stocks.

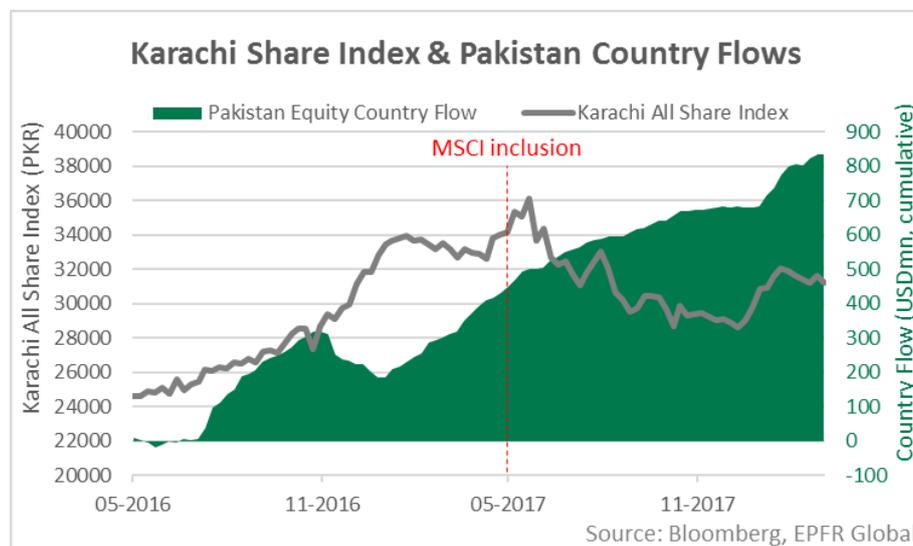
- United Arab Emirates – upgraded by MSCI to EM status in June 2013

The Abu Dhabi Securities Market rallied in the year leading up to the UAE’s upgrade to EM status in 2013. However, since then the stock index has trended gradually lower as EPFR country flow data shows large swings in investor confidence (see chart below).



- Pakistan – upgraded by MSCI to EM status in May-2017

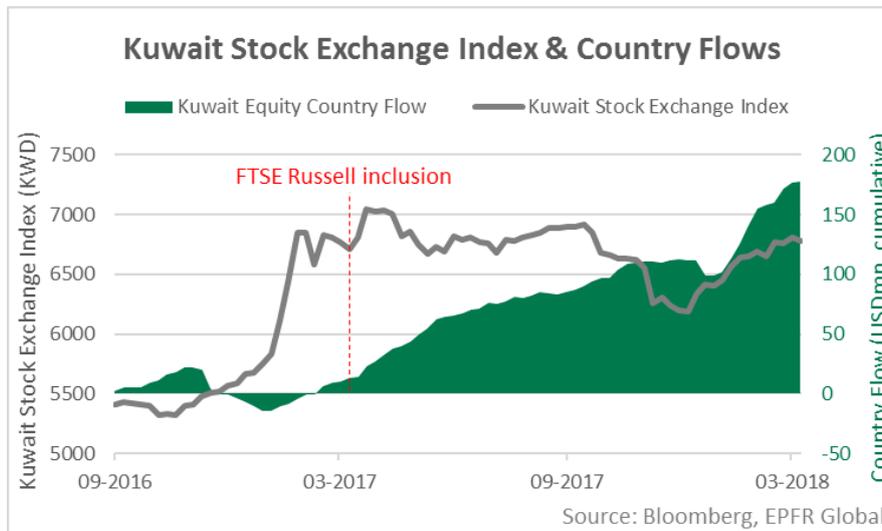
Similarly, the Karachi All Share Index hit a peak following its classification as EM by MSCI, and has since retreated. EPFR data shows that the country saw a sharp acceleration in net inflows in the year before the upgrade, amounting to approximately USD500mn. This trend has continued at roughly the same pace, with investors committing an additional USD300mn to equity funds with a mandate to invest in Pakistan.



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- Kuwait – upgraded by FTSE Russell to EM status in Sep-2017

Kuwait's Stock Exchange also rallied in the run up to its inclusion in the FTSE Russell EM index, though inflows were somewhat slower to pick up. Similar to both of the examples above, the KSE has lost ground from its post-inclusion high on broader regional dynamics.



TRADE IDEA - LONG Saudi stocks via iShares Saudi ETF (KSA ETF)

- It is clear from the recent Saudi stock market performance that investors have been moving ahead of the sovereign's inclusion into the two major EM indices.
- History suggests that ahead of the June announcement from the MSCI and in the weeks after actual inclusion, the Saudi stock rally will continue, driven by inflows.
- The iShares Saudi ETF is a potential vehicle for those wishing to express a view on the Saudi Stock Market; thus, in order to take advantage of the index inclusion we recommend a **LONG POSITION** in this ETF, targeting 29.39 and possibly 32.50.



The examples also highlight how the stock market rally is often not sustained beyond the first few weeks of index inclusion, as positioning has been adjusted. However, we believe that Saudi stocks offer a longer-term bullish narrative.

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- Market reforms initiated by Saudi Arabia that were designed to attract international investors (easing requirements for the ownership of equities by foreign investors, reducing settlement cycles and introducing short-selling), will continue attracting inflows.
- The Tadawul aims to boost foreign ownership of equities to as much as 25% in at least the next two years from about 4% currently. Additionally, the Saudi government plans to increase the number of companies listed on its stock market by nearly 50%, from 170 to 250 companies over the next four years, with an 80-strong IPO pipeline.
- Thus, the outlook for the Tadawul All Share Index remains buoyant, as highlighted by the below weekly technical chart, and we suggest remaining **LONG SAUDI STOCKS** targeting a climb to 8497 area.



- The Index is now posting fresh recovery highs (off the Oct'16 low) following a broad 1+ year consolidation phase
- The 20-Week MA is turning higher once again
- Scope is seen for a stronger recovery to the 8243/8497 area, possibly 8932 (61.8% of the 2014-2016 fall)
- Only below the Feb 7311 low (near the 20-Week MA & lower boundary of a 17-month channel) would derail the advance

Risks to the bullish outlook

- A delay in inclusion could see a near-term retracement as short-term investors/speculators lose patience.
- The long-term impact of Saudi Arabia's recent reform effort is yet to fully manifest itself.
- Perhaps a more obvious risk is Saudi Arabia's heavy dependence on oil revenues, which leave scope for significant downside in stocks on the back of any sharp correction in oil prices or increased volatility.
- Geopolitical risk cannot be ignored when considering investments in the Middle East. In terms of ongoing tensions, we would point to the war with Yemen, the diplomatic spat with Qatar, as well as the ongoing proxy-war with Iran as examples of potential flashpoints.

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