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For Investment

Saudi Capital Markets - Open? Ouverts? Offen?

Much has been made of the decision to allow overseas investors access to direct investment in the Tadawul – the flagship exchange of the Kingdom of Saudi Arabia. But as companies across the Kingdom continue to add their names to an ever-increasing IPO pipeline, advisors, and the Capital Markets Authority (CMA) alike, are advocating a cautious approach to the listing process.

There was little surprise at the announcement in December 2011 that foreign investors would eventually be permitted to invest directly in the Tadawul All Share Index (TASI), Saudi Arabia's top index of 155[1] listed companies and widely considered to be the Gulf's most attractive capital market due to its size and maturity. Though investment through swaps and exchange-traded funds had become popular indirect routes for non-Saudi nationals to track the continued growth in the petro-chemical dominated KSA economy, allowing direct foreign ownership has long been seen as a key milestone for Gulf Cooperation Council (GCC) capital markets.

A cautious and measured approach to regulatory change

Allowing foreign investment is obviously and understandably a decision that the Capital Markets Authority (CMA) in Riyadh will not have taken lightly, even with the hint of inclusion as a 'Frontier' or 'Emerging Market' under MSCI[2] classification. Subsequently, the application of a cautious and measured approach to the change appears to be their ongoing strategy, borne out by comments from CMA chairman Abdulrahman Al Tuwaijri that any opening "should be done in an orderly and gradual manner to make sure it does not impact the market's stability,"[3] as well as the fact that, as of late 2012, a formal date and confirmed details for any changes in ownership regulations had yet to be announced by the Saudi CMA. It is expected that foreign ownership will be tested on a trial basis at some point during 2013 – although it is not yet clear what format such a trial would take – and that the foreign ownership in any single Saudi company will be capped at a limit expected to be around 20 percent. It is fair to expect that a stepped process will provide comfort to investors and current Saudi-listed companies that the authorities are considering the full implications of such a large capital inflow, as well as avoiding the creation of a dangerous market bubble. This confidence in the CMA's handling of the process may have contributed in part to the seven percent Last Twelve Months (LTM) growth of the TASI,[4] although obviously the contribution from pre-emptive moves to buy securities ahead of foreign investment cannot be underestimated.

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Changes in ownership rules in recent years are not the only sign that the Kingdom is serious about becoming a global capital market. As well as continuing to use share suspensions to crack down on companies not complying with ongoing listing or reporting requirements, in January 2012 the Saudi CMA announced updated listing regulations following a public consultation period in its latest step to improve governance and the listing process. Of particular significance was the express provision that independent financial and legal advisors would be required for any Initial Public Offering (IPO) process, the former being required to confirm the issuer's eligibility for listing through a due diligence process. Such moves, when contrasted with the smaller GCC capital markets, appear to indicate that the Kingdom wishes to improve the reputation of its flagship bourse, as well as the quality of its participating listed companies.

How will capital inflow from foreign investment improve the quality of KSA issuers?

As the CMA drives for improved governance and financial reporting and opens the market to limited foreign ownership, proponents of the Tadawul would hope that market confidence will lead to the long-awaited unblocking of a pipeline that has been bulging with potential IPO candidates since the early years of the financial crisis. However, as the CMA's moves to date show, potential issuers can be expected to be vetted extensively for suitability to a listing and should be aware that any shortfalls in financial reporting, availability and preparation of historical financial information and adequacy of corporate governance could adversely impact their listing aspirations (both in time and shareholder value).

Ultimately, as Saudi companies join an ever-growing queue to go public and enjoy the benefits from additional liquidity generated from direct foreign investment, they should bear in mind that the CMA now has both the luxury and the motive to be selective over the issuers it admits. Potential issuers should be ready and aware of the updated listing requirements, the ongoing reporting requirements, as well as the wider necessity of a strong equity story to attract investors. Regardless of the fine print of the regulatory changes to the Tadawul, it is clear that 2013 will be an intriguing period of transformation for the Kingdom's public market.

by **Ross Pennington,** manager, Transaction & Restructuring Services, Middle East
Deloitte Corporate Finance Limited

Endnotes

1 As at 28 November 2012, http://www.tadawul.com.sa/
2 Morgan Stanley Capital International emerging markets index
3 Reuters, 3 April 2012, http://uk.reuters.com/article/2012/04/03/saudi-bourse-opening-idUKL6E8F31TB20120403
4 Bloomberg, 28 November 2012, http://www.tadawul.com.sa/

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