

June, 2019

KSA 'Emerges' on FTSE Russel Index

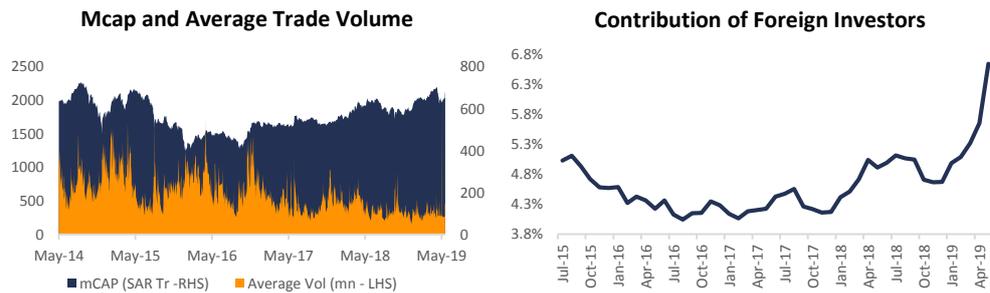
Tadawul – The bourse gets its due

Four years after Saudi Arabia opened up its stock market for the first time to foreign investors in June 2015, the FTSE Russell upgraded Saudi Arabia to the 'Emerging Market' status. The inclusion will be phased in over five tranches by March 2020, the first of which was completed in March 2019. The inclusion reflects the successful implementation of several economic and capital market reforms as part of the government's Vision 2030 to bring the country's equity market in line with international standards. The status upgrade to 'Emerging Market' in the FTSE Russel Index is a testimony to the bourse's improved transparency and accountability. In addition, the status upgrade to 'Emerging Market' on the MSCI and the S&P Dow Jones Indexes, mark an important milestone in Tadawul's journey to gain greater acceptance among global investors.

Government and CMA worked tirelessly to ensure better transparency and accountability

KSA's Tadawul, which has a market capitalization of over half a trillion dollars, is the largest bourse in the Middle East. Financial and Material sector stocks on the Tadawul All Share Index, which has 192 members, account for more than 70% of the benchmark. Since the bourse opened its doors to the foreign investors, there has been a steady rise in the proportion of the Saudi institutional investors holdings.

Tadawul Characteristics



Source: Bloomberg, Tadawul

CMA reforms pave the way

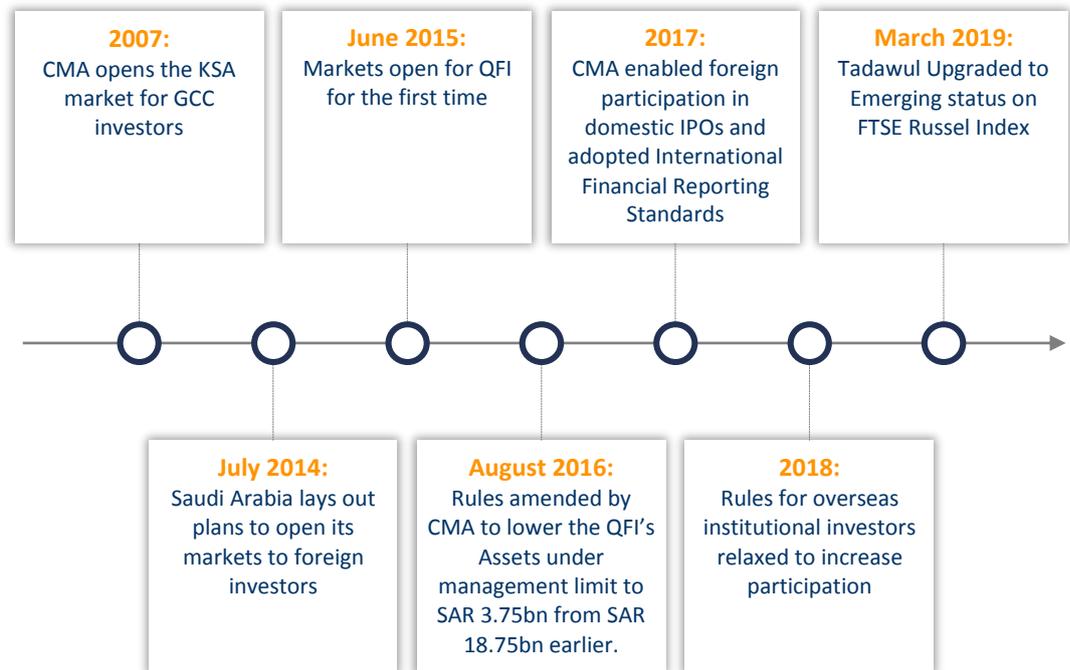
The Saudi Capital Market Authority (CMA) has played a key role in enhancing the regulatory framework of the capital markets in the country. These reforms have encouraged listed entities to raise their overall performance and improve corporate governance and transparency. The status upgrade to 'Emerging Market' on important indexes, such as FTSE Russell, substantiates the market regulator's efforts to meet the rigorous requirements for inclusion.

The process of opening up the country's capital market started in July 2014, when the government announced, for the first time, its intention to allow foreign investors to directly invest in its bourse. Previously, foreign investors could access the Saudi capital market only through derivatives and investment funds.

The market ultimately opened to qualified foreign investors (QFIs) in June 2015, albeit with some restrictions. A QFI could hold only up to 10% of shares or convertible debt of any issuer that was listed on the Tadawul. On an aggregate basis, foreign investors could own only up to 49% of listed shares or convertible debt instruments of any single issuer.

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Background and Timeline



Source: CMA, Falcom Analysis

Since then, the CMA has been actively implementing reforms to upgrade its market to bring them more in line with international standards and practices. In 2016, the market regulator lowered the Asset Under Management (AUM) limit for QFIs to SAR3.75bn from SAR18.75bn earlier. Furthermore, in 2017, CMA allowed foreign participation in domestic IPOs and adopted International Financial Reporting Standards (IFRS) for companies listed on the Tadawul. The regulator also introduced T+2 settlement, which meant that trades could be settled in two business days after the trade execution instead of the same-day requirement it previously had. In 2018, the CMA further relaxed rules for QFIs to widen the range of institutional investors. In January 2018, these reforms helped create a more conducive investment climate in the country and attracted more than over 100 important financial institutions to open accounts in the kingdom.

Vision 2030 lays the foundation for economic diversification

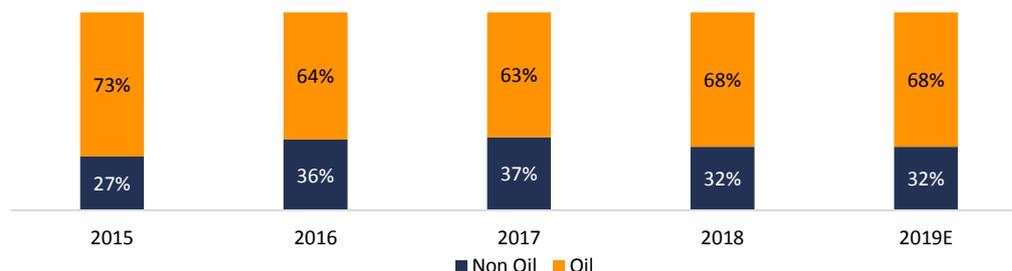
Oil revenues formed more than 60% Saudi Arabia's public revenues and therefore, any movements in oil prices have far-reaching consequences on the country's overall economy. Taking cognizance of this, the government unveiled the ambitious Vision 2030 in 2017 to diversify the economy away from dependence on oil revenues and its associated volatility. These programs were an extension of the National Transformation Program 2020, which was launched in June 2016, and the Financial Balancing Program 2020 launched in December 2016.

In January 2018, the government introduced 5% Value Added Tax (VAT) with an aim to boost non-oil revenues and reduced subsidies on fuel and electricity. Saudi Arabia also plans to unlock value by privatizing or selling a minority stake in some of its state assets to the public. In addition, the government is also aiming to boost the private sector participation. Recent social reforms in the country included encouragement of women participation in the economy and Saudization to reduce unemployment in the country.

Government's focus on non-oil sectors to spur revenue collection

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Revenue Contribution from Oil (SAR bn)



Source: 2019 Budget statement, MoF

FTSE Russell gives its stamp of approval

FTSE Russell boasts an impressive record of working closely with exchanges, regulators, and market participants in the Middle East, and it facilitates benchmarks and analytic solutions to international investors to invest in the region. The inclusion into the FTSE Russell Index comes as a great push towards more transparency and greater accountability, besides opening the doors for fresh foreign funding.

Saudi Arabia's status upgrade to 'Emerging Market' through the addition to FTSE Russell Emerging Markets (EM) is expected to be completed in five tranches over a period of 12 months. This initial tranche of 10% inclusion was completed in March 2019 followed by 15% in April 2019 to ensure a smooth transition. The remaining 75% will be implemented along with quarterly reviews in June 2019, September 2019, and March 2020 as shown in the table below.

Schedule for implementation of FTSE Russell Inclusion

Review Schedule	March 2019	April 2019	June 2019	September 2019	March 2020
Implementation Effective date	Open, 18 March	*Open, 01 May	Open, 24 June	Open, 23 September	Open, 23 March
Implementation Closing Date	Close, 14 March	*Close, 30 April	Close, 20 June	Close, 19 September	Close 19 March
Inclusion Factor	10%	15%	25%	25%	25%
Company A Quarterly Inclusion	4.90%	7.35%	12.25%	12.25%	12.25%

Source: FTSE Russell, * Following the success of Tranche 1, Tranche 2 will be held proceed on 01 May 2019, using official closing prices as of 30th April 2019

KSA is expected to have a projected weight of 0.32% in FTSE Global Equity Index Series (GEIS). Therefore, Saudi Arabia securities, which are constituents of the inclusion index on the March 2019 cut-off date, will be screened as index constituents for the purposes of both the liquidity and size eligibility screens. All other securities will be treated as non-constituents for the liquidity and size eligibility screens.

Projected weights of Saudi Arabia in FTSE Global All Cap and FTSE Emerging All Cap Indexes

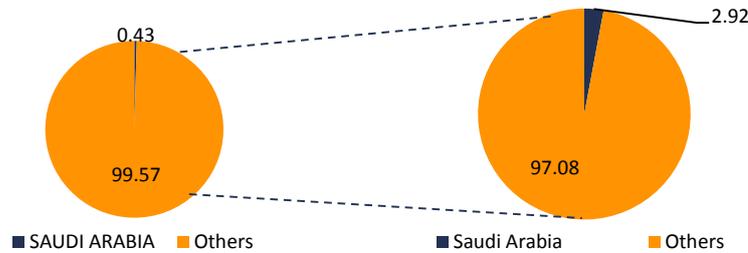
Projected weight in Global All Cap*	Projected weight in Emerging All Cap*	Projected weight in All World**	Projected weight in Emerging
0.32%	2.92%	0.34%	3.06%

Source: FTSE Russell, *Projected weight in FTSE Global All Cap based on 80 eligible securities - added during Tranche 1, effective from the open on Monday, 18 March 2019; **Projected weight in FTSE All World based on 44 eligible securities added during Tranche 1, effective from the open on Monday, 18 March 2019

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Saudi Arabia is projected to have an index weight of 2.92% in the FTSE Emerging All Cap Index. Due to this projected size in the Emerging Market index, FTSE Russell plans to implement the inclusion of Saudi Arabia in several tranches to ensure an easy transition with minimal pricing pressure on new constituents.

FTSE Constituents weight in March 2019 and March 2020E



Source: FTSE Russel, The others include China, Taiwan, India, Brazil, South Africa, Russia, Thailand, Mexico, Malaysia, Indonesia, Philippines, Qatar, Chile, Saudi Arabia, UAE, Kuwait, Turkey, Colombia, Peru, Hungary, Greece, Egypt, Czech Republic and Pakistan

FTSE Russell has strict guidelines for stock selection and market upgrade. The table below enlists the selection criteria for the index which are met by the Saudi Arabia.

FTSE Russell Index: Quality of market criteria for Saudi Arabia

Stocks are screened by free float, liquidity and minimum size and are reviewed semi-annually

Market and regulatory requirement	Formal market regulatory authorities such as SEC, FSA continuously track the market
Custody and settlement	Has sufficient competition to ensure high quality custodian services T+2 clearing and settlement
Dealing landscape	Brokerage: Sufficient competition to ensure high quality broker services Liquidity: Sufficient broad market liquidity to support sizeable global investment Transaction costs: Implicit and explicit costs to be reasonable and competitive Transparency: Market depth information/ visibility timely trade reporting process
Credit worthiness	Investment grade
GNI Per Capita Ratings	High

Treatment of Saudi Aramco IPO

The much-talked-about Saudi Aramco IPO faces an indefinite future with several delays and no confirmed date for going public. The world's biggest oil producer plans to place up to 5% of its stock on the market. Consensus estimates value to the company in the range of USD1-2tr; thus, taking a mid-range value of USD1.5tr, the investable market capitalization comes at USD75bn. This could mean an approximate projected index weight of 1.35% in the FTSE Emerging All Cap (with Saudi Arabia already transitioned into FTSE GEIS).

The most-recent reports suggest that the IPO is expected to take place by the end of 2020 or the beginning of 2021, depending on supportive market conditions. We expect the inclusion of Saudi Arabia into the FTSE Russell Emerging Index to be completed by then. In such a case, Aramco would be treated as a standard IPO based on FTSE criteria for pricing, trade volume and market capitalization. Following the Aramco IPO, we expect a substantial increase in Saudi Arabia's weightage in the FTSE Russell Emerging Index.

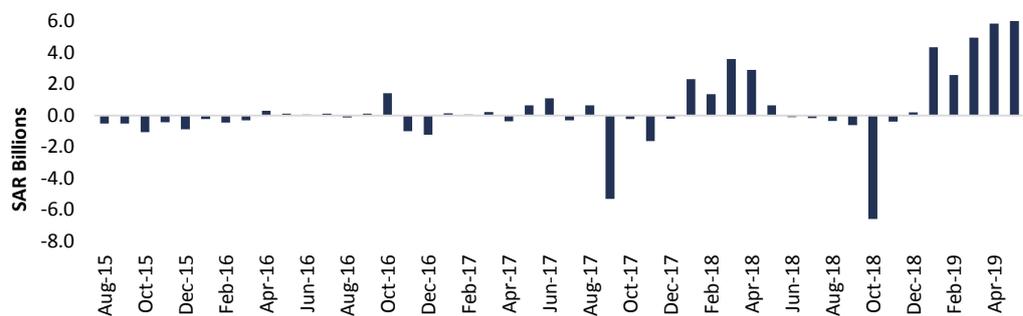
Potential impact of the status update

Large foreign fund inflows are expected to follow

Along with the status upgrade by the FTSE Russell Index, the MSCI and the S&P Indexes too upgraded KSA's status to Emerging Market. The news of the status upgrade received positive reaction from investors as the 'Emerging Market' status on several prominent indexes marks an important milestone in the evolution of the country's equity market. The Tadawul All-Share Index gained about 13% in 2019 till now compared to a 6% fall in the MSCI Emerging Markets Index during the same period. The upgrade sets the stage for further economic expansion and more foreign investments into the country to facilitate a deeper and more dynamic stock market. In addition, Saudi Arabia's economic fundamentals remain strong with the economy witnessing several positive developments since the beginning of 2019, such as reinstatement of several government projects and higher electronic and credit card transactions.

In its recent report, Moody's Investors Service informed that the addition to the MSCI EM Index will increase the trading volume and liquidity of Saudi stocks in the index, which currently has USD700mn per-day average traded volume. Besides, the inclusion will be credit positive for Saudi asset managers and boost investors' accessibility to the Saudi equity market, which in turn will increase foreign-investor ownership in Tadawul. The rating agency estimates about USD30-40bn investment inflows into the Saudi stock market as asset managers and institutional investors following this index passively will rebalance their portfolios to reduce their tracking error.

Net foreign inflow (outflow) by value



Source: Tadawul

According to Tadawul Chief, Khalid Al Hussan, the stock exchange will receive USD5bn from passive investors when the country is fully included in the FTSE benchmarks by March 2020, while as much as USD10-11bn is expected to flow into the market, following the addition to MSCI later this year.

Foreigners bought Saudi shares worth about SAR35.4bn in the first five months of the year 2019, more than any other year since the bourse was opened to them in 2015. The inflows rose when FTSE Russell started to include the country in its emerging-market category, attracting fund managers that follow the benchmark passively. Improving economic fundamentals on the back of higher oil prices, increasing contribution from non-oil sector, rising consumption and higher government spending has accelerated corporate earnings growth. Foreign investors' interest in the country is rising, which is evident by hugely successful bond offering of Aramco and the government's global bond issue in April 2019.

Outlook

Road ahead

In the recent past, the bourse has undergone a major transition phase just like the country's economy as it opens up to foreigners with the implementation of strong reforms by the CMA to ensure greater transparency and responsibility. After the status upgrade on the FTSE Russell Index, the promotion to the MSCI EM Index, is another major transformative liquidity event for Saudi Arabia. All the efforts by the government and the CMA have put the country on the global map as a formidable investor destination. With further opening up of the economy and society, KSA may well be on the path for strong economic growth.

Risks and unknowns

Along with the optimism surrounding the status upgrade, some concerns also prevail as there are possibility that the uptake is not as strong as it is expected and the actual passive inflows do not match up to the expected inflows. Tadawul is a highly-concentrated index with the financial and material sector accounting for 70% of the total weight. Also, Tadawul is relatively expensive compared with its peers in the emerging market index, trading on a multiple of 20.02 times current earnings, compared with an MSCI Emerging Market average of 13.58.

Besides, economic prospects of Saudi Arabia may weaken if oil prices remain flat. Although the government is working towards diversification, oil still remains the major source of revenue for the country. Furthermore, if US Fed fails to raise its interest rates further, it may reduce margins for its large financial sector that greatly benefitted from the currency peg with the US dollar. Rising geopolitical tensions due to regional conflicts, where Saudi Arabia plays an important role, can greatly hinder its growth prospects.

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Appendix – List of companies from Saudi Arabia included in the FTSE Russell

Companies	Sector	FTSE Constituent weight (%)	Market Capitalization (SAR bn)	Current P/E Ratio
Saudi Basic Industries	Petrochemical	0.05	360	18.5
Al Rajhi Bank	Banking	0.05	179.3	16.6
National Commercial	Banking	0.03	176.4	16.8
Riyad Bank	Banking	0.02	78	14.9
Samba Financial	Banking	0.02	72.9	13.4
Saudi Telecom	Telecom	0.02	222	20.3
Almarai Co	Consumer staples	0.02	53.7	27.1
Jarir Marketing	Retail	0.01	20.4	20.8
SAFCO	Petrochemical	0.01	35	19
Saudi Arabian Mining	Industrial Investment	0.01	60.8	56.1
Saudi Electricity	Utilities	0.01	74.3	51.3
Saudi Kayan	Petrochemical	0.01	19	18
Yanbu National	Petrochemical	0.01	35.4	16.3
Alinma Bank	Banking	0.01	36.4	13.6
BUPA Arabia	Insurance	<0.005	11.6	20.52
Dallah Healthcare	HealthCare	<0.005	3.7	36.6
Dar Al Arkan	Real Estate	<0.005	12.5	64.1
Emaar Economic City	Real Estate	<0.005	8.3	NA
Etihad Etisalat	Telecom	<0.005	18.4	440.4
Fawaz Abdulaziz	Retail	<0.005	4.8	45.7
Middle East Healthcare	Healthcare	<0.005	2.6	25.6
Mobile Telecom	Telecom & IT	<0.005	7.1	13.1
Mouwasat Medical	Healthcare	<0.005	9	24.8
National Industrial.	Petrochemical	<0.005	11.4	11.4
National Petrochemical	Petrochemical	<0.005	12.2	12
Rabigh Refining	Petrochemical	<0.005	17.6	27.9
Sahara Petrochemical	Petrochemical	<0.005	15.3	14.1
Saudi Airlines Catering	Agri and Food	<0.005	6.9	15.6
Saudi Cement	Cement	<0.005	10.7	27.4
Saudi Ground Services	Transportation	<0.005	5.3	14.5
Saudi Industrial Invest.	Petrochemical	<0.005	11.3	13.4
Saudi Intl. Petrochem	Petrochemical	<0.005	15.3	NA
Saudi Pharmaceutical	Health Care	<0.005	3.2	90.6
Saudia Research & Mar.	Media	<0.005	7.4	NA
SAVOLA	Agri and Food	<0.005	18	NA
Tawuniya	Insurance	<0.005	9	NA
Yanbu Cement	Cement	<0.005	4.9	39.6
Abdullah Al Othaim	Consumer staples	<0.005	7	23.2
Advanced Petrochem	Petrochemical	<0.005	11.6	14.8
Al Hammadi Co	Health Care	<0.005	2.6	31.5
Al Tayyar	Consumer disc.	<0.005	5.4	NA
Bank Albilad	Banking	<0.005	20.3	17.3
Bank Al-Jazira	Banking	<0.005	20.5	11.7
Qassim Cement	Materials	<0.005	4.2	35.6

Source: Bloomberg FTSE Russell, Argaam; Note: MCap is taken as of 20th June 2019 and constituent weights are as of 29th March 2019



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