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PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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SAUDI ARABIA'S DEBT ISSUE AND MARKET LIBERALIZATION

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Saudi Arabia is working to liberalize markets and diversify economy as part of a "National Transformation Plan"

Foreign participation in local equity market remains limited thus far; economy still highly oil-dependent

Saudi Arabia's $17.5b bond (largest ever outside DM) speaks to the kingdom's desire to access international capital markets to meet current budget needs

Foreign access to local equities and EM index inclusion remain important next steps

In 2014, Saudi Arabia announced that they would open their equity market to foreign participants, with the intention of broadening investor participation in the local market and an eye toward eventual inclusion in MSCI's Emerging Market Index. Although the kingdom took the first step toward opening its market in 2015, the Saudis are still working to accelerate what, to date, has been a slow process. So far, foreign investment still accounts for only a small fraction of market cap. Even with recent advancements and liberalization, the soonest Saudi Arabia could be included on MSCI's watchlist for EM inclusion is 2017, which would imply inclusion in late-2017 in the most bullish case, or more likely 2018. Saudi would bypass the Frontier Markets index given its market cap of over $300b.

There are still issues needing resolution before Saudi can be considered for EM inclusion. Foreigners must be able to access the market locally. As mentioned, Saudi Arabia technically opened their market to foreigners in 2015, but the application process has been vague, inconsistent, and fairly disorganized. Only a few investors have been able to obtain local access. In addition, cash settlement today favors the retail investor (which makes up >90% of the liquidity), while institutional investors favor a longer settlement period (t+2, not t+0). Settlement schedules familiar to institutional investors in more mature markets are expected to be put in place next year. While the pace of progress has been disappointing to date, there is reason for optimism.

Recently, Saudi Arabia completed its first international bond issue, the first of its size for a developing country. Investor interest in the issue was significant, as the deal was massively oversubscribed with Asian central banks, European sovereign wealth funds and Middle Eastern banks among the buyers. The proceeds of this issue will help Saudi with payables (including government worker wages) and will inject liquidity in the banking system. This helps to shore up Saudi's budget which is distressed due to the prolonged period of low energy prices. This may have the downstream effect also of improving corporate earnings, which would support investor interest in Saudi equities and the country's effort to gain EM status.

While strong investor support is interesting in and of itself, the bond issue is interesting from an equity investor's standpoint because it speaks volumes about Saudi's place in the global economy. The country is running a deficit because of low oil prices, yet Saudi historically has played a large role in setting the price of oil. With more players today (including Iran and U.S. shale), Saudi's focus on maintaining market share and managing production takes a different shape. In the prospectus for the bond issue, Saudi announced that its reserves of oil could last 70 years at current prices; this has called into question the viability of these reserves and whether some may become stranded over time. The country is already beginning to invest in renewables given its high domestic consumption of oil.

Recognizing the need to diversify its economy and seek international capital, the Deputy Crown Prince Muhammed Bin Salman issued a "National Transformation Plan" in early 2016. This plan calls for liberalizing the economy as well as selling down some state assets, including Saudi Aramco, one of Saudi's main crown jewels. There has been internal disagreement about this plan, as the culture of the country has historically been more self-contained and conservative—the country does not even issue tourist visas. The bond issue shows that the kingdom is beginning to coalesce around this plan (whether by choice or not), and this advances the timeline for potential EM inclusion.

We believe that the success of this recent bond issue is another encouraging sign that Saudi Arabia is making progress in the effort to open its markets. While equity market liberalization has faced challenges, market access and settlement issues are being addressed. When resolved, having direct access to the market will increase the investment opportunities available, while participation from a broader range of global institutional investors should lend liquidity, growth, and stability to this market as it matures.

BIOGRAPHY

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Asha joined Acadian in 2007. Her responsibilities include portfolio management, research on responsible investing, stock selection strategies for developing and established markets, and enhancements to the Acadian investment process. Prior to Acadian, Asha was an investment banker at Goldman Sachs, where she executed energy and power deals in the emerging markets. She has also worked at Johnson & Johnson in a strategy role to improve product access in developing markets. Early in her career, she worked in microfinance in India. Asha has traveled to over seventy countries and lived in six. She obtained A.B. and B.S. degrees from Stanford University and an M.B.A. with Honors from The Wharton School at the University of Pennsylvania. Asha is a CFA charterholder and a member of the Boston Security Analysts Society.

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