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MIDDLE EAST ROUNDTABLE 2012

TARGETING RETURNS

An expert panel discuss the development of regional financial centres, MSCI migration, regulation and the potential internationalisation of the Saudi Arabian market

PARTICIPANTS:

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Mike Cowley, head of DSS, Mena, global transaction banking, Deutsche Bank

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Richard Souri, vice president, MSCI

Robert Ansari, executive director, MSCI

David Sanders, chief investment officer, Invest AD Asset Management

Christian Kern, head of Mena equity research, J.P. Morgan

Chair: How is asset management developing in the GCC?

Sanders: I've been in Abu Dhabi for nine years. In the early days, 2004/6, there were lots of brokers and asset managers with so many different funds. The global economic collapse as well as Dubai's issues resulted in fewer players, but increased professionalism. Also, local asset managers with local funds and local clients started to evolve into regional managers with regional or global clients. Also, new regulations have led more asset managers to launch Ucits funds. Stronger regulatory regimes have attracted third-party money from more regulated jurisdictions.

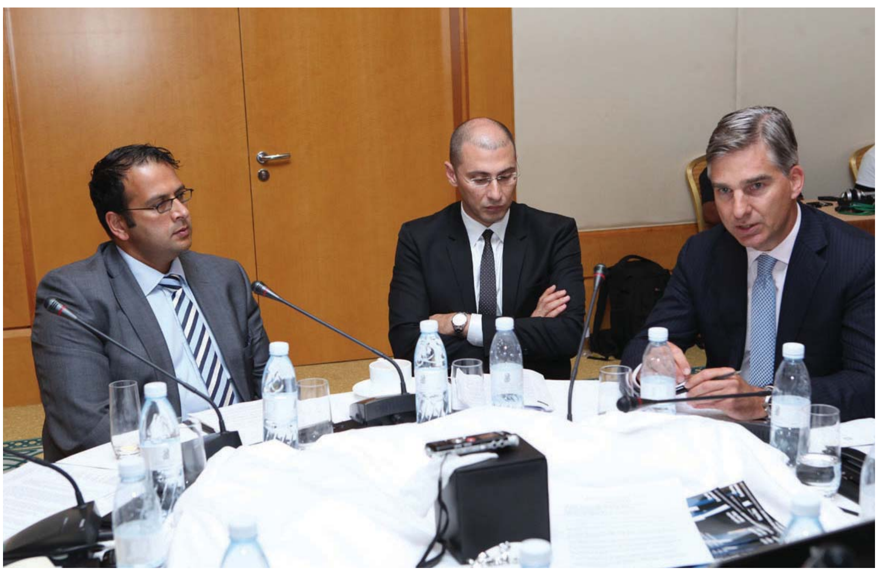
Das: I would question whether the local asset management industry is growing significantly. It has certainly shrunk since 2008. Data is very difficult to come by in this region but the size of the mutual fund industry (ie not including the discretionarily managed portfolios) is about $30bn in the GCC – of that $20bn is in Saudi Arabia so the other five countries only have $10bn. The average fund size here is $25m to $30m. If we don't have scale, it doesn't pay for the asset manager or the service provider. If regional investors want Ucits funds, or funds manufactured and domiciled elsewhere, it makes it even more difficult for the locally domiciled funds to flourish.

Sanders: A few years ago Europeans were potentially interested in all funds from the region – now they have to be Ucits. An investor in frontier markets wants the extra confidence of Ucits compared to local registration. When we talked to potential investors they said 'come back when you have Ucits', so we did exactly that. Within the region it is less of an issue but several local or regional banks have told us they would prefer Ucits if they're going to put them on a platform for retail investors. High net worth individuals are less concerned.

Chair: How significant are the recent regulatory developments in the UAE? Are they a net positive?

Cowley: The Emirates Securities & Commodities Authority (Esca) is consulting both the buy and sell side on new regulatory proposals. Esca is trying to implement and enforce regulations, which should be admired and applauded. They are looking at how banks should split their administration and custody business away from the asset management piece and are trying to establish standards in the region. We now have a position where some banks already appoint custodians and administrators but some don't and have done everything in-house – this will force an industry standard that is internationally accepted.

Esca is looking to roll out a raft of regulations over the next two or three years – this is the just the first one, others will follow. Admittedly, they have taken a tough one to look at first as they are also addressing the distribution side of the fund industry, which looks to be creating some tough decisions for firms to take. Quite rightly they want to grow the fund industry, but questions are being raised as to how they're trying to achieve it. Regulations on



distribution need the right level of balance to ensure investor protection while keeping sufficient momentum for the industry to reach a larger investor base as well as create sound, innovative products. This needs very careful consideration and consultation to be successful.

Das: There are pros and cons to every regulation. It depends on your perspective. People selling foreign funds here will have a more difficult task, as they've got to get explicit approval from Esca. That might help the local funds industry as it might encourage people to domicile funds here. The regulation is a good first step, but the real test would be to keep it dynamic and evolving in tune with industry demands and international best practice.

Cowley: There were over 483 separate comments made on the draft regulation that was issued last January. It's taken 18 months to get through these so we are encouraged that they are engaging and working with the market participants when they issue new regulations. Esca has taken a tough area to tackle first and it has done a good job in terms of consulting the market – the acid test will be sound regulation achieving a secure framework while ensuring industry growth.

Chair: What could be done to attract more funds to domicile locally?

Das: Too many retail investors invest directly in stock markets. There has to be a cultural change driven by an awareness generation programme, educating retail investors that they they can also invest through mutual funds. For the message to sink in there needs to be a concerted campaign and demonstrable results.

Investors must have confidence in local regulations. Local residents seem to be more comfortable investing in a Cayman-domiciled fund than a DIFC one – why is that? We must have investor awareness and confidence in the funds that are domiciled locally. We must also have product variety – not just GCC or Mena equity funds.

Souri: Product creators should ask what European institutional investors are looking for, to start really looking more deeply at strategies. This is something we are doing a lot at MSCI. We are creating a lot of strategy-type indices, strategies that we are seeing a number of pension funds adopt such as minimum volatility, risk-weighted or value funds. It is something we don't yet see a lot of in the region and could allow a manager to differentiate itself.

"The aim of the MSCI's rules is to ensure that they appropriately reflect the international investable opportunity set of equities"

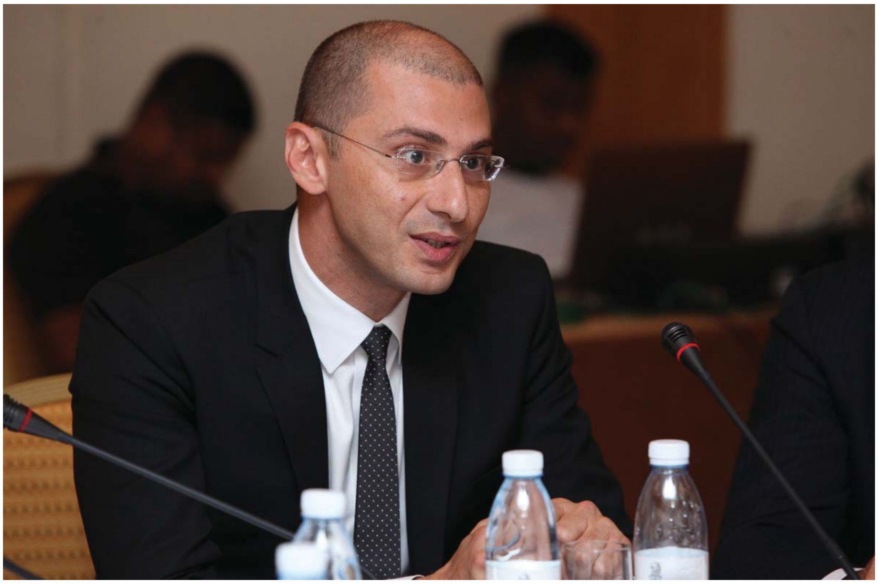
ROBERT ANSARI, MSCI

Chair: How could the region's stock markets attract more investors?

Kern: Institutional investors are keen to participate more in the region's growth – opportunities in growth areas such as tourism and transport are currently limited. Stock market capitalisation is concentrated in banks, telecoms, real estate and petro-chemicals so opening up new areas would facilitate diversification. Broadening the sector spectrum would attract additional investors.

"Rather than just accommodating the MSCI requirements, exchanges are now asking 'What do we want the exchange to be? How can we get the market right? How can we grow it?'"

MIKE COWLEY, DEUTSCHE BANK



"Once markets are developed institutional investors will naturally be attracted – whether they have been migrated by MSCI or not" RICHARD SOURI, MSCI

Sanders: The consolidation of stock markets would be attractive to institutional investors. The buy side would like to see it but it is probably years away. One of the big issues is liquidity, which is very, very low compared to a few years ago outside Saudi Arabia. Liquidity begets liquidity, so it would be nice to see more options. Shorting can develop a stock market and shouldn't be feared.

Cowley: Confidence in the stock market is needed to get people to list. It's difficult for companies to tap a market if a lack of existing listings is not attracting the needed breadth of investor.

The markets were thriving four years ago but that was more speculation than actual investment. Now we are looking for people to invest and stay in the market and give us depth and stability over a period of time. To do this, market features are being addressed. The UAE, Qatar and some other exchanges are starting to develop their stock markets in line with MSCI criteria, in terms of emerging markets inclusion, with the aim to attract the investor base wanted to provide the depth and stability mentioned.

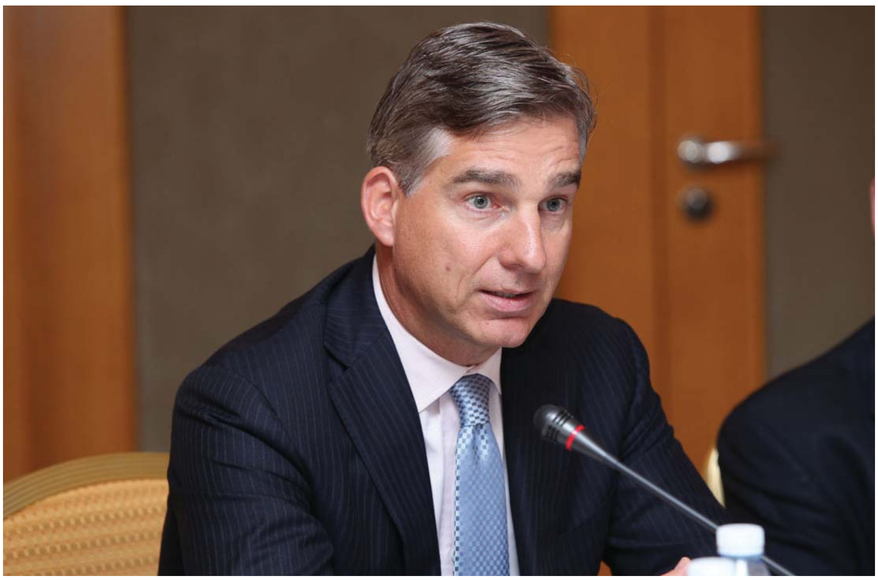
Elalfy: We should remember the stock market is supposed to help economies grow. Instead of looking for privatisations and the listing of large companies – that do not require capital – we should open stock markets for new projects. This could be supported by regulation. It is preferable to just listing for the sake of developing the stock market.

An issue for stock markets in the region is that the number of investible sectors is limited. For example, in Egypt oil and gas are off limits – unless you are Shell or British Petroleum. New projects could be opened up. This is also true for important sectors such as education and health. Developing the stock market in this way would help limit social issues down the road – opportunities for investors could lead to the Arab population getting essential services.

The Arab Spring was not really driven by the political situation – it was basically driven by the economic situation in the region. The region has a huge amount of human capital – if you have the right calibre people combined with the right technology we can further develop the capital markets and the people will have a new sense of ownership in these markets.

Das: We are missing an opportunity now as the world is going through an economic recession, and even Asia is slowing down. In this environment the GCC countries stand out but unfortunately the strong growth in their economies is not translating into growth in the capital markets.

Part of the reason is that the drivers of the economy are not wholly reflected in listings in the market and the markets are very skewed in favour of some sectors. The concerns about liquidity are also valid. Another point is corporate governance, which is very important if we want to make these markets more dependent on institutional rather than retail investment. In order to attract institutional investors you need better quality analysis and research and companies need to be comfortable with the higher standards of disclosure that accompanies a public listing. In order to infuse diversity and liquidity in the markets we need state-owned companies and family-owned enterprises to come to the market.



"The returns can be much higher than in developed markets. It's a wonderful opportunity for a sell side researcher to add value to institutional investors" CHRISTIAN KERN, J.P. MORGAN

Chair: What is the solution to the IPO problem?

Elalfy: The dream is to have a single Arab Stock Exchange – but it is far fetched. We could start with dual or multi-listing of stocks. Admittedly, the experience has not been great – where there has been dual listing the trading has been done mainly in one country. For example, the Commercial International Bank in Egypt cancelled its listings in Kuwait and Abu Dhabi as there was no trading.

But multi-listing could potentially help tap sources of funds for new projects or expansion out of home markets. It would also help promote disclosure, drawing attention from multiple analysts and regulators.

It can be argued though that investing in regional markets today, even without a common regulator or exchange, can be done with relative ease, especially with the technology available. Yet, there would be nothing better than to have a single regulator for Arab markets. This could be under the Arab League umbrella, although it has higher priorities at the moment. If the regulators combined forces they could offer investors just one set of regulations, if not a single exchange, and would not each face separate piles of consultation feedback.

Cowley: It's a very fair comment – but I am not sure we will see this happen in any of our careers. There are too many other issues at hand and we don't see such sophistication in more mature markets/regions.

Chair: Is corporate governance and investor relations practice holding back investors?

Cowley: Corporate governance is a major issue. Research analysts didn't even really cover stocks six years ago – we have many large regional and international players covering stocks now so it's a huge step forward as companies now have to be more transparent. Certain companies now have investment relations (IR) managers and take governance seriously. At the same time [as promoting themselves] the companies are effectively selling the infrastructure – whether the DFM, QE or ADX – by saying 'we've got coverage on our stock, governance is stronger, look at our numbers'. It's not a gloomy picture – real progress is being made.

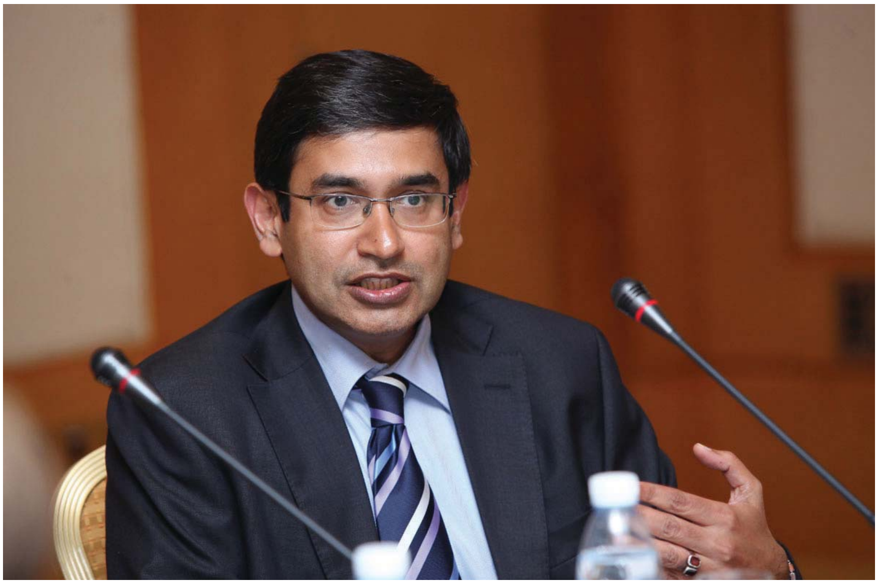
Volumes may be low now but they – listed companies, exchanges – are taking steps to build out capital markets. They have got the coverage, they're building the infrastructure to a high standard and they're looking at improved corporate governance. Remember these markets are only 10 to 15 years old so in some respects, hats off, they've done a good job so far.

Kern: The Middle East Investor Relations Society (Meirs) has gained a lot of momentum over the last couple of years. It is a young organisation that has made strong inroads in setting up country chapters across the region. Among others, the Saudi Stock Exchange, and also Bahrain, Qatar and the UAE, are providing tremendous support to IR awareness campaigns. The job of equity researchers has become easier as corporate communication channels have improved.

Sanders: Definitely. We are still in a frontier market but corporate governance has

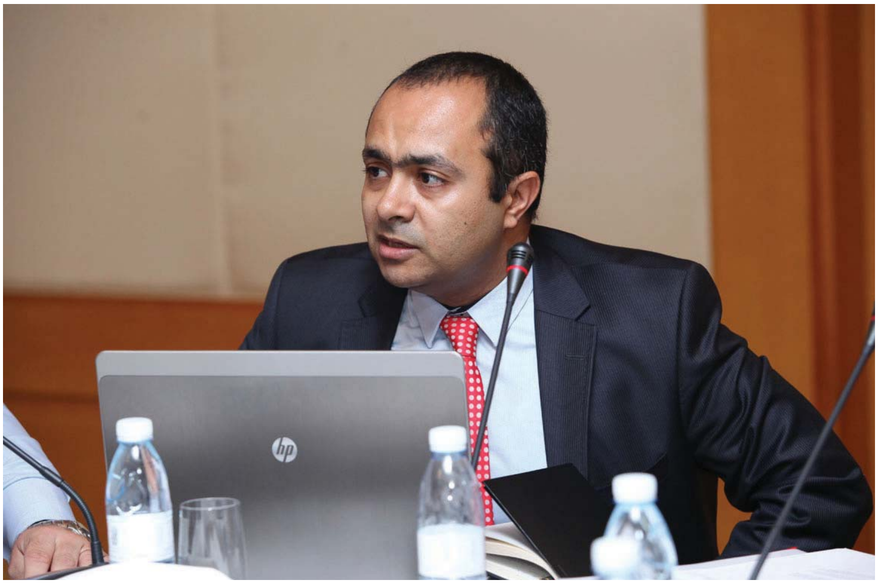
"A few years ago Europeans were potentially interested in all funds from the region – now they have to be Ucits"

DAVID SANDERS, INVEST AD ASSET MANAGEMENT



"The problem is that some of the issues are not technical issues like DVP – so they are not within the remit of the stock exchange"

ARINDAM DAS, HSBC SECURITIES SERVICES



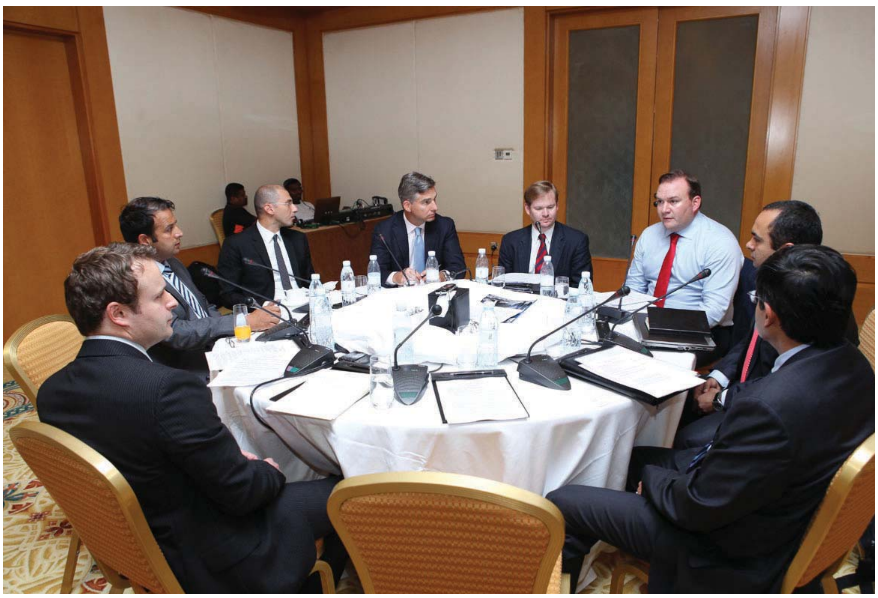
"Instead of looking for privatisations and the listing of large companies – that do not require capital – we should open stock markets for new projects" AMR ELALFY, MUBASHER FINANCIAL SERVICES

improved tremendously. Just a few years ago companies acted as if their books were trade secrets. We would ask 'what keeps you up at night? What are your issues?' And they'd reply 'Who told you we had issues? We don't have any issues'. Now you see much more interest in engaging with investors. Companies have set up investor relations functions, and executives are doing analyst and fund manager conference calls.

Chair: Are firms regaining their appetite for holding investor roadshows?

Das: Back in the Gulf boom years of 2007/8, stock exchanges would take the top 10 or 20 companies to London or New York to meet investors – I haven't heard of too many recently. But equally you need a story to tell on a roadshow – otherwise investors will be disappointed and won't come to the next one.

There are a number of positive steps that have been taken to improve the market infrastructure and some more are in the pipeline – but I don't think we are piecing them together to articulate a story that is compelling to international investors.



Sanders: At the time of the 2007/8 London roadshows, GCC companies didn't need capital but they told their story anyway. Now they are actively seeking capital so they realise the importance of corporate governance.

A few years ago, I would surprise people in the GCC when I told them that governance and transparency is actually much better in Africa. But if you think about it, African companies actively look for capital all the time – GCC ones are learning.

Das: That's the point. I hear a lot of mixed messages – Do the local markets need more capital? Do we need foreign investors? This leads some investors and intermediaries to ask the question – as the region is flush with funds, is there really an appetite for reform? The MSCI upgrade of UAE and Qatar to emerging markets is not as much a talking point today as it was even a year back. Some of the messages also get lost in a game of Chinese whispers – when the exchanges say 'we will do many of these things not because of MSCI but because we believe it's good for our market' – this gets translated to external investors as the exchange will not do the things MSCI wants.

Cowley: The MSCI process almost became a box-ticking exercise for the exchanges. This seems to have changed a little and exchanges are now looking at taking another approach. Rather than just accommodating the MSCI requirements, exchanges are now asking 'what do we want the exchange to be? How can we get the market right? How can we grow it?' while ensuring it meets MSCI requirements needed for an upgrade to emerging markets.

Souri: That's a very good point. The MSCI criteria are a mechanism to provide markets with what institutional investors are looking for – it's really just a reflection of their requirements. The important thing is that this is about market development. Once markets are developed institutional investors will naturally be attracted – whether they have been migrated by MSCI or not.

Sanders: I respectfully disagree. Investors that don't invest in our region say they don't because they use the emerging markets benchmark. Pension plans haven't taken the dive into frontier markets. They have emerging market managers that buy in the region for alpha only – they can choose to ignore it. Once UAE or Qatar get into the MSCI these institutional investors will have to make a decision – it will become the new benchmark.

Chair: It would be very easy for some countries to fulfil MSCI's criteria, which would result in inflows of quality capital. Why do they not implement those final few pieces?

Ansari: The short answer to your question is that we do not know. MSCI welcomes the evolution of things such as Qatar foreign ownership limits and UAE false trades. Each year, when these countries have been up for migration, MSCI gave transparent reasons why they've failed at that time.

Kern: There will obviously be additional capital flowing into the region as a lot of the asset managers use MSCI benchmarks – passive as much as active managers.

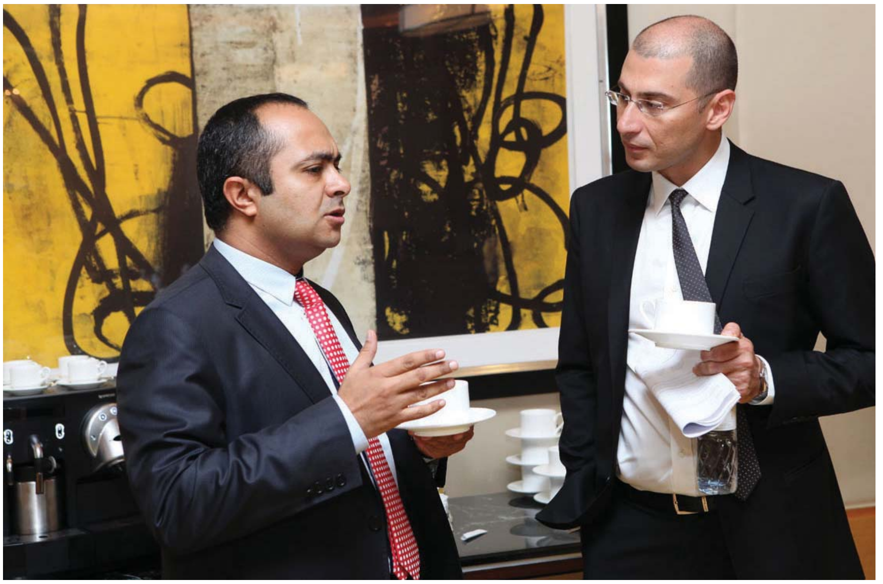
Ansari: The important thing is that MSCI tries its hardest to ensure that the rules that we implement are transparent, so all countries within the region are aware of them. The aim of the MSCI's rules is to ensure that they appropriately reflect the international investable opportunity set of equities.

Cowley: A question for MSCI – the UAE was given a number of criteria 18 months ago that were all valid in terms of what it needed to address. Now we have a situation where some, in fact most, have been fulfilled, many around DVP. The main issue I now hear is around dual accounts and failed trades – which we are told is being worked on by the market. When that's in place, and everything else is going in the right direction, does that mean in December we are all good to go? It seems that, from the DFM or ADX point of view, they have addressed the rightful concerns and I wonder what else could be put in their way to stop the upgrade.

Ansari: It could just be a simple case of the requested things needing time to prove that they are working. If you fulfil, say, false trades criteria and you have dual accounting taken away, you then need to have it tested over a period of time.

Cowley: That's it exactly. You said you want more liquidity – but one of the things an MSCI upgrade brings is more liquidity – so it's completely chicken and egg. And an upgrade would have a big impact on the number of people needing to cover the stocks in terms of analysts for firms who have clients investing in the emerging MSCI.

Souri: Migration should have very little impact – because international institutional investors would increasingly be in the markets.



To answer the reluctance to implement question – to relax ownership limits – other emerging markets have cited concerns of a strategic nature, not wanting to give up ownership of firms in certain strategic sectors to a foreign entity.

Das: The problem is that some of the issues are not technical issues like DVP – so they are not within the remit of the stock exchange. There are policy issues that the government needs to address like the one of foreign ownership limits.

Kern: These are complex decisions with a lot of stakeholders involved – policymakers, regulators, exchanges and owners of companies – and there are security issues as well. The financial market perspective can sometimes be narrow-minded. The ultimate decision makers have to consider a much broader spectrum of information and arguments.

Das: I also feel that they are less comfortable with foreign investors entering the stock market through portfolio investment than via FDI (foreign direct investment). It is understandable that markets with a large retail investor base will be concerned about how foreign investments can impact their markets, but as we can see from other emerging markets that have followed this route, it is possible to set policy guidelines and filters at the sector/company level to control the type of investors who can invest in the country and up to what levels.

Sanders: It [QFI schemes] is a phenomenon that's happened all around the world. When countries open up they don't trust foreigners. Malaysia famously shut things down when it was thought hedge funds destroyed the market. But over time they discover there are different types of investors.

Many local regulators fear hot money and worry markets will be taken up and down on the whims of hedge funds. But institutional money is long-term pension money, the sort these markets desperately need. Opening up to foreigners can actually make the market more stable. A lot of the hot money comes from local retail investors.

Chair: What opportunities are there currently? And which types of manager are best positioned to benefit?

Elalfy: We need to develop the local asset management business in the region, and link it to the stock market development and MSCI classification. It is a self-fulfilling prophecy. When MSCI opens up a market, you get the usual suspects. In Egypt, you can only invest in ten or 14 stocks – so how can asset managers get alpha when just investing in MSCI? You are letting MSCI do your job, selecting only the top stocks.

We research analysts have a duty to our clients to not just wait for regulations or for MSCI to open up the market. We should be doing research on the ground, meeting mid or small sized companies with growth stories – the big ones are over-researched.

Kern: It's unfortunate for institutional investors and asset managers that some hidden jewels do not yet fully meet their investment criteria. We set up equity research for J.P. Morgan in the region for the great alpha opportunities. In developed markets, companies are often over-researched. The returns can be much higher than in developed markets.

It's a wonderful opportunity for a sell side researcher to add value to institutional investors.

Elalfy: International investors will probably take easier opportunities elsewhere. But local asset managers can't just pick the big companies – or net of fees they will be underperforming the market.

Chair: Will Saudi Arabia open up and, if so, what will the arrangements look like?

Kern: For me this is not a question of if but when. The question is how – a QFI scheme, direct opening or something new? Less noise just means work is being done behind closed doors and we will see it bear fruit over the coming months. The most likely outcome is a gradual opening of the market.

The QFI model is proven and has been very respectful of existing stakeholder concerns. You don't want sudden volatility. A QFI scheme could, for instance, consider years of track record and assets under management. The healthy Saudi volume is currently about 90% retail with the remainder being institutional money – P-notes account for around 2%.

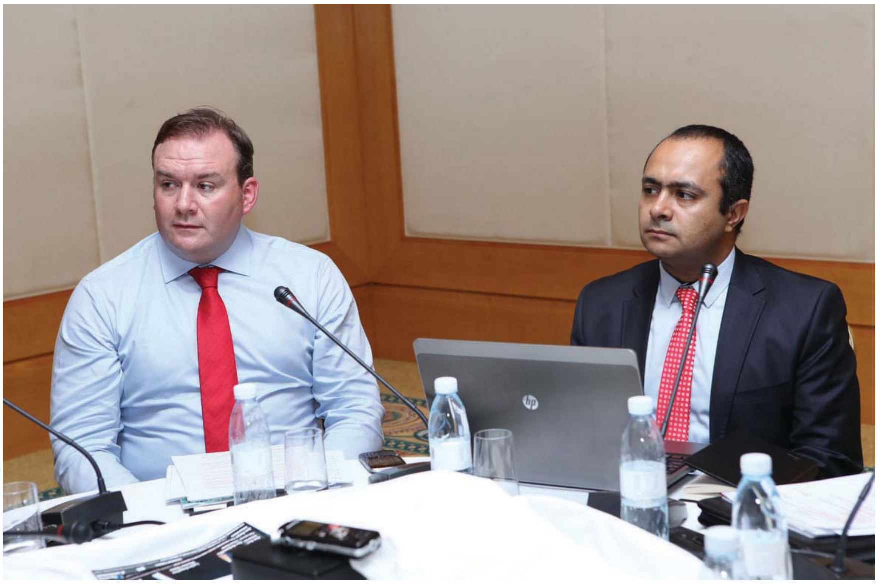
Das: Given that the only conduit into Saudi is through P-notes and mutual funds – including some recent ETFs – there's actually not a huge amount of incremental money coming in through these routes. That's what I can't quite comprehend when we talk about the huge appetite foreign investors reportedly have for this market.

Kern: Asset managers tend to have a maximum 10% counterparty risk with a particular broker. It is a critical factor as some P-note providers may not meet your risk criteria – you may be by default underweight Saudi.

Das: The buzz that was there at the beginning of the year about Saudi opening up has fizzled out. The message that the market hears is that it will open up, but not now. It dampens investor's enthusiasm, leaving them wondering what will trigger a change in policy.

Chair: What would be the effect on the region?

Elalfy: If this was to happen, undoubtedly all aspects will be thoroughly assessed by CMA, the local regulator, including both potential positive and negative implications on the market and local investors. The CMA is known to exercise utmost caution in preserving both the integrity of the markets as well as safe guarding the interest of investors, in particular the small investors.



Kern: Some are concerned capital would flow from the rest of the GCC to the Saudi market, cannibalising liquidity in the rest of the GCC – I am a strong contrarian of that view. I believe it is going to have a positive knock-on effect for other stock markets in the region. Suddenly the region will be on the map of every single asset manager. Saudi liquidity [daily volume] is currently more than $1.6bn – bigger than Russia, South Africa or Turkey. Very few people know that today.

Sanders: Saudi valuations have historically been higher than in the rest of the GCC and Mena – one theory is there's a liquidity premium in Saudi. Another issue if it was actually opened up is that Saudi's world-class petrochemical and industrial companies would be compared internationally, which is not now happening. Saudi is the low cost leader and investors would no longer have to exclude it.

Kern: The Saudi market trades on a 2012 P/E of around 12 times while GCC 200 index currently sits on about 11 times – that's the liquidity premium – so its not too much of a premium.

Elalfy: But if IPOs are limited to Saudis, foreign investors would have to pay a higher valuation for a company that had only recently been listed on the market.