Muted enthusiasm after MSCI upgrade for UAE and Qatar

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Regulatory changes needed to attract institutional investors to stock markets, say analysts

MSCI's upgrade of Qatar and the UAE to emerging markets status will have a limited effect on institutional investments, according to analysts and fund managers.

Limited liquidity and regulation is holding back foreign investments into the region's stock markets and from profitable companies wanting to launch initial public offerings (IPOs), they say.

US-headquartered index compiler MSCI, used as the benchmark for more than 500 funds globally, announced on 12 June that the UAE's and Qatar's stock markets will be upgraded to emerging markets status in May 2014. MSCI was positive about the improvements in foreign ownership limits in Qatar and the enhancement of settlement systems in both Qatar and the UAE.

The upgrade, which the countries have been eyeing since 2008, is seen as a nod of approval from institutional investors worldwide. Expectations about the amount of foreign inflow vary from $400m (local Emirates NBD) to $800m (the UK's HSBC) to $1bn (the US' JP Morgan), but Nasser Saidi, president at the local Nasser Saidi& Associates and former chief economist at Dubai international Financial Centre (DIFC), says these estimates should be treated with caution.

"A part of the recent rise in the markets is due to speculation that Qatar and the UAE would indeed get a reclassification. Generally in advance of an actual reclassification, there will be an overshooting phenomenon where prices go beyond what is dictated by economic fundamentals. After that prices will decline."

While the MSCI upgrade is likely to increase interest from institutional investors, it does not mean fund managers will immediately rebalance their portfolios.

Regional markets do not have many heavily traded stocks and struggle with limited liquidity. The minimum number of stocks that are required to pass MSCI's criteria is three and UAE and Qatar beat this by a wide margin. But in Abu Dhabi, Dubai and Qatar, the top five weighted stocks have accounted for over half of the recent surge in each exchange's trading volumes.

Qatar and the UAE will initially comprise a small part of the overall emerging markets index – around 0.5 per cent and 0.4 per cent respectively.

Coupled with foreign ownership restrictions, investors have few options to tap the regional markets, as limits are set at a maximum of 49 per cent.

In Qatar, at 25 per cent of free float that is even less, although [the government has announced a number of companies will be improving that to 25 per cent of overall market capitalisation].

An increase in foreign ownership limits is currently being discussed by the UAE government, but no clear date has been set for the foreign investment law to take effect and in many cases listed companies already have significantly lower foreign ownership levels than the current limit. The latter applies to listed companies in Qatar as well.

“There are several important stocks in Qatar - namely Qatar National Bank (QNB) and Industries Qatar (IQ) - where the room open to foreign investors is limited because of low ownership limits and relatively high foreign ownership. These stocks could be at risk of a lower weight in the index if foreign room falls, though MSCI may make exceptions because they are seen as important,” says Simon Kitchen, a strategist at Egypt-based EFG Hermes.

He estimates that for IQ and QNB, the two biggest stocks by market capitalisation, there is around $4bn in foreign room (the proportion of shares still available to foreign investors relative to the maximum allowed) remaining. Foreign ownership levels and and foreign room tend to be higher in the UAE, he says.

“Initially, nearly all stocks in these [Qatar and the UAE] markets will do well, mainly driven by retail investor interest – emerging market fund investors already have significant exposure to these markets.”

Ghadir Abu Leil-Cooper, head of Europe, the Middle East and Africa, and global frontier market equities at London-based Baring Asset Management, said investors would increase their focus on UAE and Qatar, but provided no details about whether the Baring Mena Fund would increase its exposure to the countries.

“We hope that the authorities in both countries will use the upgrade as a platform to further increase foreign ownership limits and implement other structural improvements to their exchanges,” she said in a statement.

Sam Vecht, head of the emerging markets specialist team and portfolio manager of the Frontiers Investment Trust at New York-based BlackRock, said in a statement that “while we welcome the move, it is unlikely to have any significant near-term impact on how we manage our client portfolios”.

Gary Dugan, chief investment officer for Asia and the Middle East at Coutts, the Royal Bank of Scotland’s wealth division, says he is “not sure if the MSCI upgrade will have a massive impact on how much emerging markets fund managers allocate to the region”, although it would “raise the bar in terms of corporate governance and the openness of these markets to foreign investors, and that will be a move in a positive direction.”

Corporate governance regulation is either lacking or not enforced, according to Saidi, as financial reporting is either not done or not done on time. Investor relations officers are not always in place, and he says there needs to be more transparency about deals that are or are not being made.

Liquidity is another area that is being held back as more companies would need to list regionally to raise trading volumes, which in turn would also attract investors who are seeking more diversification in their portfolios.

Currently, the top weighted stocks in the UAE and Qatar are financial institutions, followed by real estate companies.

A string of local companies are understood to be planning IPOs, but many such as the local Al-Habtoor Group's IPO, worth an estimated $1.6bn, either have been postponed indefinitely or have said not be launching until market valuations improve or regulation is changed.

"If you want to get the IPO market moving again, you need to let the market decide what initial prices should be," says Saidi.

"There should be a book building exercise. [With the exception of Nasdaq Dubai] at the moment, valuations are based on regulators looking at book value and economic projections of profitability. This has led to speculation on large IPOs in the first days of trading."

Also, profitable companies seeking listings may not want to do so on local exchanges. Regulation requires them to increase their capital at IPO, and they face a minimum amount of 'free float' (the amount of shares that can be traded on the market), which would mean giving up some of their ownership.

"Change in regulations is holding up a lot of IPOs. If you can't sell capital that already exists, that rules out lots of profitable companies listing," says a banker who works on UAE deals.

It is possible that this might change in the near future, as the UAE's Securities and Commodities Authority is currently discussing ways to relax these laws, sources say.

As a result of IPO regulation, some companies looking for higher liquidity are opting to list on stock exchanges abroad. Al-Noor Hospitals Group is currently seeking a listing on the London Stock Exchange after NMC Health listed on it last year. Other regional companies, such as DP World, have cross-listed in London, or are considering it, such as Abu Dhabi National Energy Company (Taqa).

Increased international exposure also leads to valuations that are more in line with international markets, where price-to-earnings and price-to-book ratios are higher than in the region.

It is unlikely that regional exchanges and other financial entities are happy about losing business and they may start advocating for change in regulation as well.

"Big day for UAE capital markets – upgraded to MSCI Emerging Market Status. Good move, but more work to do to attract institutional liquidity," tweeted Jeff Singer, chief executive officer of the DIFC Authority, following the announcement.

But even if issues in regulation are resolved marking an improvement, local institutional investors such as pension funds and insurance companies, which typically operate as the backbone of a market, would also be needed, says Saidi.

For the moment though, stock markets are still on the rise. Over the past year, the Dubai Financial Market General Index rose more than 40 per cent year-on-year, while the Abu Dhabi Securities Exchange General Index (ADXGI) climbed more than 30 per cent. Qatar Exchange’s index increased around 10 per cent.