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UNDERSTANDING THE UPGRADE

What does the Emerging Market Upgrade Mean for the UAE and Qatar?

AS OF JUNE 1, THE FINANCIAL markets of the UAE and Qatar will graduate (as accredited by index compiler MSCI) from frontier to emerging market status.

This reclassification decision had been three years in the offing before the announcement was made on June 12 last year. Qatar will have a 0.47 per cent weight in the MSCI Emerging Market Index, while the UAE will have 0.58 per cent, adding up to just over 1 per cent of the market total.

MSCI has included the largest 10 Qatari companies and 9 UAE companies to the All-World index and to the Emerging Markets Index. Qatar National Bank SAQ, Industries Qatar QSC and National Bank of Abu Dhabi PJSC will be the biggest additions.

But what does this all mean?

EQUITY MARKETS ON A BULL RUN

After a scare in the summer of 2013, global developed markets have been on a bull run, as investors became convinced that the start of Fed tapering did not imply a quick move to raise policy interest rates.

Closer to home, anticipating the reclassification, and supported by strong macro fundamentals, both the UAE and Qatar markets have had a good run – further aided by positive sentiment surrounding the Dubai Expo 2020 and (less so) the Qatar World Cup 2022.

As of May 26, the Abu Dhabi Securities Exchange had risen 17.7 per cent, trading at 5,048.58 points while the Dubai Financial Market had surged 47 per cent in the same period, trading at 4954.62 points. In Qatar, the benchmark had risen 29 per cent to 13393.34. Indeed, Dubai has been one of the top market performers.

WHY DOES RECLASSIFICATION MATTER?

The immediate expected benefit of reclassification will result from an anticipated increase in portfolio flows with the entry of foreign institutional investors and passive or index-tracking investors that will have to rebalance their portfolios to include Qatar and the UAE.

Typically, institutional investors are restricted to investing in developed and emerging markets, so the reclassification highlights the entry of a new class of investors into the domestic market.

Estimates suggest that the reclassification is likely to bring anywhere between $300 million to $4 billion worth of foreign inflow to the two markets.

The increased exposure to international investment might also lead to an increase in initial public offerings (IPOs), thus potentially leading to a much-needed deepening of the equity market in the region.

Reclassification is no panacea for market ills, poor corporate governance or underperformance.

DANGERS OF OVERSHOOTING

But reclassification is no panacea for market ills, poor corporate governance or underperformance.

Empirical results based on 13 market reclassifications since 1980 suggest that the date of announcement of a market upgrade does have a positive effect on market returns. But the evidence also suggests a negative effect on the market in the actual event of reclassification, with prices falling.

While this may seem paradoxical, such a result is consistent with the initial announcement of a reclassification leading to an "overshooting" of prices.

This involves investors speculatively bidding up securities prices and returns before the actual reclassification event in the expectation that foreign investors will be entering the market, resulting in prices falling following the actual reclassification event.

Exuberance and market hype accompanying market reclassification can lead to asset price bubbles. It is likely that these factors have driven equity prices upward over the past year. The clear warning is the risk that asset prices will be falling after the June 1 reclassification event.

MUCH REMAINS ON THE REFORM AGENDA

Typically, reclassification (both upgrades and downgrades) have followed or been accompanied by economic and financial policy reforms, including improvements in market infrastructure.

Both Qatar and the UAE have already undertaken technical market

infrastructure reforms to upgrade into emerging market status: the former by raising the limits on foreign ownership of companies and the latter by improving the securities settlement systems.

Following the reclassification announcement, a few banks have raised the amount of outstanding shares eligible to be purchased by foreigners – key to attracting foreign investors.

But much remains on the reform agenda.

OPEN MARKETS TO FOREIGN INVESTORS

Governments in the GCC, including reclassified Qatar and the UAE, have to liberalise access to their markets by removing barriers to ownership by foreign investors.

Currently, the maximum amount of shares available to foreign investors is 49 per cent. The UAE cannot claim to be a global hub while imposing barriers to entry and access to markets.

Opening the market to foreign investors is a key reform that needs to be implemented in the near term, while liquidity is another major concern of investors. More companies would need to list regionally to provide greater diversification potential and raise trading volumes, which in turn would also attract portfolio investors.

Currently, the top weighted stocks in the UAE and Qatar are financial institutions, followed by real estate companies. These do not provide sufficient exposure to the underlying economies and their prospects.

CONSOLIDATE STOCK MARKETS

Integration of stock exchanges is imperative to developing a liquid market, with a common trading system and a single system for clearance and settlement and security depository.

The first step in this direction would be the unduly delayed consolidation of the three UAE exchanges to form a common market. The strategic objective for the UAE is to have a deep, broad and liquid financial market, building the capacity of managing and controlling their own wealth and being able to allocate capital internationally from their home base thereby gaining international financial power.

Integration of UAE's three stock exchanges is imperative to develop a deep and liquid financial market.

IMPROVE CORPORATE GOVERNANCE

The reclassification is likely to raise the bar in terms of corporate governance in Qatar and the UAE. Foreign institutional investors will not be as complacent or inactive as domestic retail investors.

Corporate governance rules need stronger enforcement and the timeliness and content of management and financial reporting needs a major overhaul.

Reclassification is an opportunity for listed companies to improve their corporate governance and investor relations in accordance with international standards, improve disclosure and transparency and comply with international reporting standards.

BUILD AN INSTITUTIONAL INVESTOR BASE

Sound, well-functioning financial markets require a broad base of institutional investors to anchor markets. While reclassification will attract foreign investors, they are not a substitute for domestic institutional investors such as pension funds and insurance companies, which typically operate as the backbone of a market.

Both the UAE and Qatar will need to develop a legal and regulatory framework to build domestic pension systems as well as liberalise an over-protected insurance sector.

MARKET RECLASSIFICATION SIGNALS LIBERALISATION

The reclassification is likely to encourage both countries to further liberalise access to their markets by raising foreign ownership limits for investors and adopting investor-friendly legislation and regulation. They should not miss the opportunity to open up and develop their capital markets.

Efficient, well-functioning markets typically lead to increased private-sector participation in capital markets and would encourage local family businesses to turn into public shareholding companies.

Other GCC countries will also emulate and follow Qatar and the UAE. The opening up of Saudi Arabia to foreign investors is probably one of the next most anticipated events in the region. GB