Understanding the Upgrade – Opinion piece in Gulf Business, Jun 2014

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As of June 1st 2014, the UAE and Qatar financial markets will graduate (as accredited by index compiler MSCI) from frontier to emerging market status. The reclassification decision had been three years in the offing before the announcement was made on June 12, 2013. Qatar will have a 0.47% weight in the MSCI Emerging Market Index, while UAE will have 0.58%, adding up to just over 1% 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. 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 home, anticipating the reclassification, and supported by strong macro fundamentals, both UAE and Qatar markets have had a good run, also 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. Various estimates suggest that the reclassification is likely to bring anywhere between USD 300 million to USD 4 billion worth of foreign inflow to the two markets[1]. 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.

Market reclassification is important because it acts as a signal to investors that economic and financial policymakers are committed to maintaining the institutional and technical conditions to retain their new status as an emerging market. This implies that Qatar & the UAE commit to maintaining orderly market conditions and markets accessibility, which include openness to foreign ownership, unfettered capital flows, an efficient operational framework, sufficiently large size listed companies and liquidity, and importantly, the stability of the institutional framework governing the markets, which includes laws and regulations,.

Dangers of Overshooting

But reclassification is no panacea for market ills, poor corporate governance or underperformance. In a research report[2] we examined the effect of reclassifications on markets. The 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 on the actual event of reclassification, with prices falling.

While this may seem paradoxical, such a result is consistent with the initial announcement of an announced 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 1st 2014 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%. 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, (the Arab world's second biggest economy after Saudi) 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.

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 Financial Reporting Standards.

Build an institutional investor base. Sound, well-functioning financial markets require a broad base of institutional investors to anchor markets. While reclassification while 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 Qatar and UAE market reclassification is likely to encourage them to further liberalize access to their markets by raising foreign ownership limits for investors and adopting investor-friendly legislation & regulation. They should not miss the opportunity to open up and develop their capital markets. Efficient, well-functioning markets typically leads 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. A decision to switch the two-day weekend from Thursday and Friday to Friday and Saturday can be read as a preliminary move to long-awaited reforms that grant foreign investors greater access to the relatively Saudi stock market. The UAE and Qatar’s reclassification to emerging market status is likely to herald a greater ouverture, openness and liberalisation of the GCC economies. This should be supported by domestic and foreign stakeholders.

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[1] JP Morgan predicts that the 0.4 per cent weighting means that net inflows arising from the upgrade will amount to around USD 442 million for the UAE, while HSBC puts the figure

closer to USD 370 million. EFG Hermes expects an inflow of USD 739mn while Credit Suisse remains most optimistic, estimating that in a best-case scenario USD 4 billion could be re-allocated to the UAE.

[2] *Saidi, Nasser, Prasad, Aathira and Naik, Vineeth (2012): "From Frontier to Emerging: Does Market Reclassification Matter?"Available at SSRN: http://ssrn.com/abstract=1994623*