



Overview

In November 2016 we visited Saudi Arabia in order to evaluate the general level of asset management expertise in the country and identify potential managers with whom we could invest. Our agenda also included a meeting with the management of a prominent holding company.

Saudi Arabia may be on course for classification to Emerging Markets status in 2019 by index providers MSCI & FTSE. The inclusion is expected to lead to passive inflows of approximately US\$9.5bn¹. We anticipate that an early allocation to Saudi Arabia ahead of this significant market event may give us the first-mover advantage that could be beneficial for our clients.

The Kingdom of Saudi Arabia is the largest country in the Middle East, the second largest country in the Arab world and the fifth largest country in Asia by landmass. Saudi Arabia occupies most of the Arabian Peninsula, with the Red Sea to the west, and the Persian Gulf to the east.

The country has the largest natural resource deposits in the Middle East, not just oil and gas, but also precious metals and minerals. According to the latest data from Saudi Aramco, Saudi Arabia's crude oil and condensate reserves stand at 261.1 billion barrels², approximately one-fifth of global reserves. Saudi Arabia's production averaged 10.4 million barrels a day in 2016³, of which approximately 7.8 million barrels a day are exported⁴. This makes Saudi Arabia the world's largest oil exporter. The primary oil fields are concentrated in the eastern province which extends along the Persian Gulf.

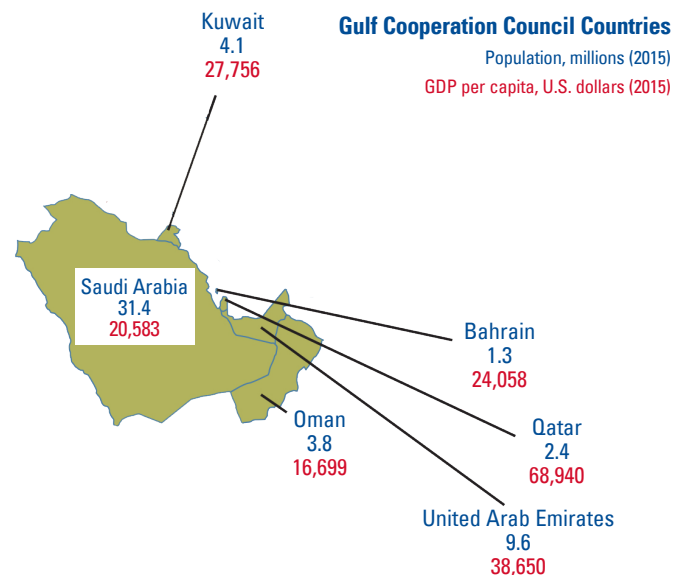
The country's precious stone and mineral deposits are located in the so-called Arabian-Nubian Shield, an exposure of Precambrian crystalline rocks along the Red Sea, in the western part of the country. This area is a major source of several minerals, including gold, silver, copper, zinc, chromium, manganese, tungsten, lead, tin, aluminium, and iron. Gold alone has been discovered at approximately 600 sites, some having a production capacity of at least 400 tonnes of ore per day. Iron reserves are estimated at 84 million tonnes. Saudi Arabia also has deposits of rare metals such as tantalum and niobium (25 percent of world reserves)⁵.

Snapshot: Saudi Arabia's Capital Market

Name of Local Index	Tadawul All Share Index (TASI)
Index Ticker	.SASEIDX Index
Market Capitalization	US\$448.256 billion
Number of Listed Companies	176
Number of Sectors	15
12M Average Daily Traded Value	US\$1.214 billion

Source: Bloomberg as at 31 December 2016

Map of Gulf Cooperation Council Countries (GCC)



Source: IMF Regional Economic Outlook Database

¹ Source: EFG Asset Management Strategy Note, MSCI, FTSE.

² Source: Key facts and figures. Saudi Aramco Annual Review 2015.

³ Source: Bloomberg

⁴ Source: Joint Organisations Data Initiative (JODI), Saudi Arabia Oil exports September 2016

⁵ Source: Fanack Chronicle of the Middle East & North Africa

Saudi Arabia is not currently included in the MSCI EM indices, due to onerous restrictions on foreign ownership of stocks. This is in the process of changing with regulation being enacted to lower the threshold for obtaining Qualified Foreign Investor (QFI) status and settlement and custodian practices being brought into line with international norms.

The impact of a lower oil price on the fiscal situation has prompted the Saudi authorities to explore strategies for diversifying the economy, which will require foreign capital, expertise and a more market orientated system.

Saudi Arabia's oil reserves are located within onshore, shallow wells. The reserves are easily recoverable with extraction costs per barrel estimated at c.US\$10-20⁶. At current daily rates of production Saudi Arabia could continue pumping until at least 2080. The Kingdom's current urgency in diversifying the economy along with a reticence to curtail production until very recently is built on speculation that by 2040 demand for, and therefore the price of oil may be significantly lower than today. At current growth rates, installed renewable energy capacity, potentially led by Solar, may have jumped to the extent that oil demand growth may be falling sharply in the next two decades. This is especially so if further technological advances are made in electrical storage and transmission.

Saudi Arabia's oil is controlled by Saudi Aramco, a 100% state owned company. The government has announced plans to privatise up to 5% of Saudi Aramco by the end of 2017. Authorities

have indicated that Aramco's IPO valuation could be as high as US\$2trn, making the company the largest (listed) global enterprise by a factor of 3 (for comparison, the largest global company at present, Apple, has a Market cap of US\$609bn⁷). Besides managing the reserves of Saudi Arabia, Saudi Aramco is a fully integrated, global petroleum enterprise. The company is involved in exploration, production, refining, distribution, marketing and petrochemicals manufacturing. Saudi Aramco owns a number of subsidiaries and affiliates that are located across the globe including China, Egypt, Japan, India, the Netherlands, the Republic of Korea, Singapore, the United Kingdom and the United States. We would note that the company is in the process of streamlining and concentrating its operations in advance of the IPO and there remains much uncertainty over the inclusion or treatment of the reserves which the Kingdom has clearly indicated they wish to maintain sovereignty over. However, the value of Saudi Aramco is expected to reach at least US\$2trn resulting in a free float of US\$100bn for a 5% stake, easily making the company a top 20 MSCI Emerging Markets index component.

If Saudi Aramco's 5% free float is added to the market cap of the MSCI Saudi Arabia Index (US\$114bn as of 31st December 2016), which not only adjusts for free float but accounts for foreign ownership limit restrictions imposed by Saudi Arabia's Capital Markets Authority (CMA), we estimate the index market cap post the Aramco IPO to be over US\$200bn. This would equate to approximately 5% of MXEF. This, therefore, may have significant implications for all Emerging Market investors.

Constituents and Passive Flows Simulation

Ticker	Part of MSCI KSA Provisional	Est. MSCI EM Weight (%)	Est. FTSE EM* Weight (%)	Est. MSCI Passive (US\$m)	Est. FTSE Passive (US\$m)	Total Passive (US\$m)
SABIC AB	Yes	0.44%	0.52%	1,070	459	1,529
RJHI AB	Yes	0.34%	0.40%	821	353	1,174
NCB AB	Yes	0.22%	0.26%	535	230	765
SAMBA AB	Yes	0.15%	0.18%	370	159	529
STC AB	Yes	0.15%	0.17%	358	153	511
MAADEN AB	Yes	0.11%	0.13%	275	118	393
RIBL AB	Yes	0.11%	0.13%	269	116	385
SECO AB	Yes	0.09%	0.11%	229	98	327
ALMARAI AB	Yes	0.09%	0.11%	226	97	323
SAFCO AB	Yes	0.09%	0.10%	212	91	304
EEC AB	Yes	0.08%	0.09%	194	83	277
SAVOLA AB	Yes	0.07%	0.09%	183	79	261
ALINMA AB	Yes	0.07%	0.09%	182	78	260
YANSAB AB	Yes	0.06%	0.07%	149	64	213
ARNB AB	Yes	0.04%	0.05%	110	47	157
EMAAR AB		0.04%	0.05%	109	47	156
ALBI AB		0.04%	0.05%	103	44	148
JARIR AB		0.04%	0.05%	94	40	134
KAYAN AB		0.04%	0.04%	88	38	126
BUPA AB		0.03%	0.04%	83	36	119
SACCO AB		0.03%	0.04%	82	35	118
TAWUNIYA AB		0.03%	0.03%	71	31	102
ALTAYYAR AB	Yes	0.03%	0.03%	69	30	99
NIC AB		0.03%	0.03%	65	28	94
APPC AB		0.03%	0.03%	65	28	92
YNCCO AB		0.02%	0.03%	61	26	87
CATERING AB		0.02%	0.03%	57	25	82
MOUWASAT AB		0.02%	0.03%	54	23	77
ALARKAN AB		0.02%	0.03%	53	23	76
SIIG AB		0.02%	0.03%	53	23	76
SGS AB		0.02%	0.02%	48	21	69
PETROBR AB	Yes	0.02%	0.02%	47	20	67
MEH AB		0.02%	0.02%	46	20	66
ALHOKAIR AB	Yes	0.02%	0.02%	44	19	62
PETROCH AB		0.01%	0.01%	25	11	36
Total		2.66%	3.42%*	6,502	3,010*	9,512

*Source: MSCI, FTSE, EFG Hermes estimates.

MSCI & FTSE Constituents and passive flows simulation under the 49% Qualified Foreign Investor Ownership Limit.

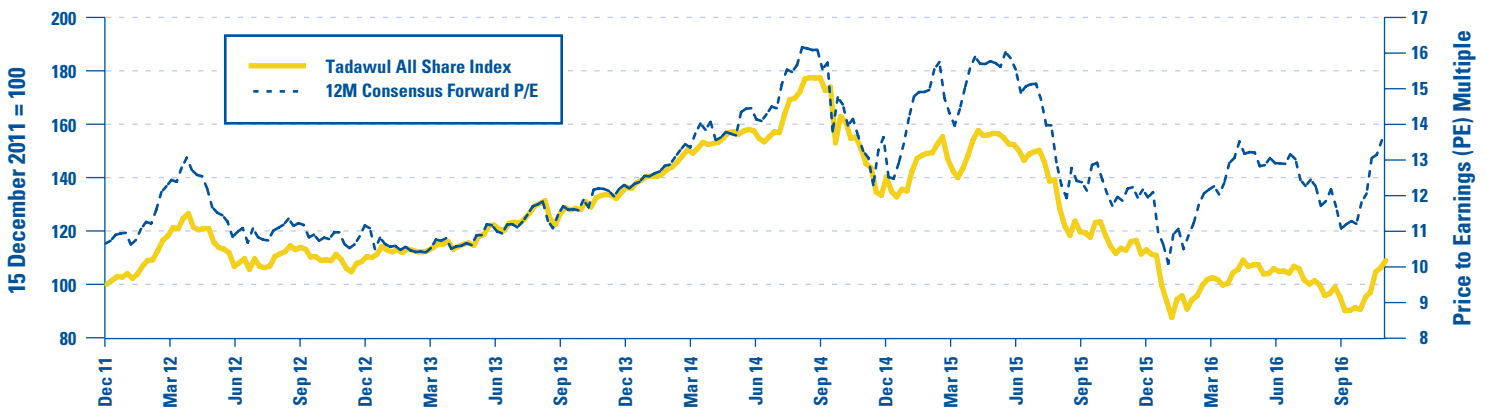
⁶ Source: Rystad Energy

⁷ As at 30 December 2016

As at 31 October 2016, the level of the stock market was 46% below its most recent peak in September 2014, and traded at 11x 12m forward earnings. However, the recent rally in November puts the market valuation closer to the 5-year average. Recent market strength has been driven by:

- ▶ **Potential for inclusion in the MSCI Emerging Markets Index:** A number of local managers had been anticipating that Saudi Arabia would be placed on the MSCI review list in November to begin official consultations on EM inclusion in June 2017. Based on the most recent rules for QFIs and foreign ownership limit changes, Saudi Arabia could have a weight of 2.7% in the MSCI EM index. This is comparable to Malaysia or Indonesia, potentially leading to passive inflows of US\$6.5bn. However, MSCI's announcement on the 14th of November lacked any reference to Saudi Arabia being placed on the review list; but we note that in September 2014 MSCI launched a provisional Saudi Arabian index.
- ▶ **Government debt repayments:** The Saudi government had been delaying payments owed to the private sector which had negatively impacted the local economy in 2016. These delayed payments amount to almost US\$90bn. Following a recent royal decree circulated by the ministry of finance the government set aside US\$27bn to pay a portion of these liabilities by the end of the current fiscal year 2016.
- ▶ **Record Bond issuance:** In October 2016 the Saudi government conducted the largest emerging market bond sale, raising US\$17.5bn in the Kingdom's first international offer which was oversubscribed almost four times. The bond issuance reflected positive investor appetite despite the fragile economic outlook and weak oil prices.

Stock Market Performance and Valuations



Source: Bloomberg



Source: City of London Investment Management Files

Investment Options

Currently there are no dedicated closed-end funds (CEFs) that focus solely on Saudi Arabia, nor are there any dedicated offshore OEFs. One NYSE listed Exchange Traded Fund (ETF) exists (KSA US). This was launched in Sep-2015 but has assets of only US\$4.7m.

There are three onshore listed ETFs in Saudi Arabia which have combined assets of US\$11.5m.

There are a number of holding companies listed in both Kuwait and Saudi Arabia that provide exposure to the Saudi market - Saudi Basic Industries (SABIC), Savola Group and Kingdom Holding are the largest examples.

SABIC is a materials focused conglomerate which manufactures a broad range of oil derived products from polymers to fertilizer. It is the largest listed non-Financial in Saudi Arabia and following spin-offs in the past 5 years has approximately 11% of its market cap in three listed

subsidiaries. The company's main market is Asia (China) which makes up 40-50%⁸ of its exports. Historically, SABIC's management has been investor-shy, but this is changing as there is greater pressure from the local authorities towards transparency and investor education. SABIC is one of the largest employers in the Kingdom (40,000 employees) and over 80% of its local workforce comprises Saudi nationals.

Savola Group (Savola) is the largest staple food company in Saudi Arabia, with a market share of 62% and 85% in edible oil and sugar, respectively. It is also the largest producer of branded edible oil in the world.⁹ The company operates in three core segments: the Foods segment which manufactures and distributes edible oils, sugar and pasta products; the Retail segment includes the company's hyper and super market operations; whilst the Plastic segment manufactures and markets plastics for industrial and commercial use. The company's investment activities cover their ownership in its subsidiaries and listed associates. Geographically, Saudi Arabia contributes 73% of the company's revenue, followed by Iran (11.4%) and Egypt (6.7%)¹⁰. A significant portion of the company's net assets (94%)¹¹ are held in publically listed subsidiaries. The company has a market cap of US\$5.5bn¹² and is based in Jeddah.

Kingdom Holdings is the investment vehicle for Prince Al-Waleed bin Talal, and holds mainly foreign companies. However, the company is illiquid with only 5% free float¹¹, and suffers from poor corporate governance.

There are 46 Asset Management companies based in Saudi Arabia. This includes asset managers with a focus on local, international and GCC companies. That said, only 13 manage funds that are larger than SAR50m (US\$13m) in size and have a three year track record. We met with two of these local management groups with strong medium to long term track records. We also met with Morgan Stanley, who has been active in the Kingdom since 1976 on the investment banking side and has been managing funds locally since 2008, as well as EFG Hermes, who has been managing assets in Saudi Arabia since 2007.

The two local managers we met with were SAMBA Capital and NCB Capital. SAMBA Capital is the asset management arm of Saudi-American Bank, and NCB Capital is the asset management arm of National Commercial Bank, the 2nd largest bank in the GCC. NCB Capital is also the largest Asset Manager in the Kingdom with over US\$21bn in assets under management (AUM)¹³.

Along with the strong performance relative to the Tadawul All Share index of listed Saudi companies, generally, they also all shared the following characteristics:

- Fundamental, bottom up, active management style
- Research teams organized by sector
- Clear investment objectives and risk management guidelines
- Foreign born/educated CIO or asset management head
- At least one or two CFAs in the management team
- Segregated risk/compliance function
- Understood the need to engage with the Capital Markets Authority (CMA)
- Low staff turnover

In conclusion, we are initiating our due diligence on selective managers and holding companies, ahead of classification to Emerging Markets status. Saudi Arabia could be on course to becoming a top 10 Emerging Market within three years. We intend to grow our investable universe in the MENA region via the constant evaluation of investment opportunities in Saudi Arabia. In early 2016, Saudi Arabia began a process of reviewing and introducing multiple reforms across a number of economic sectors, including energy, labour markets, pensions, and health. The most notable were the reduction of domestic subsidies for energy and water, rationalisation and cancellation of a number of infrastructure related projects and increased labour market regulation. We view the steps taken by the government of Saudi Arabia to implement reform and diversify the economy away from hydrocarbons as positive, despite the risk of implementation and execution.

Ahmed Jaber, IMC, December 2016

⁸ Source: Saudi Basic Industries

⁹ Source: Savola Group

¹⁰ Source: Bloomberg

¹¹ Source: CoL Internal Valuation Models

¹² Source: Bloomberg, as at 12 December 2016

¹³ Source: NCB Capital



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