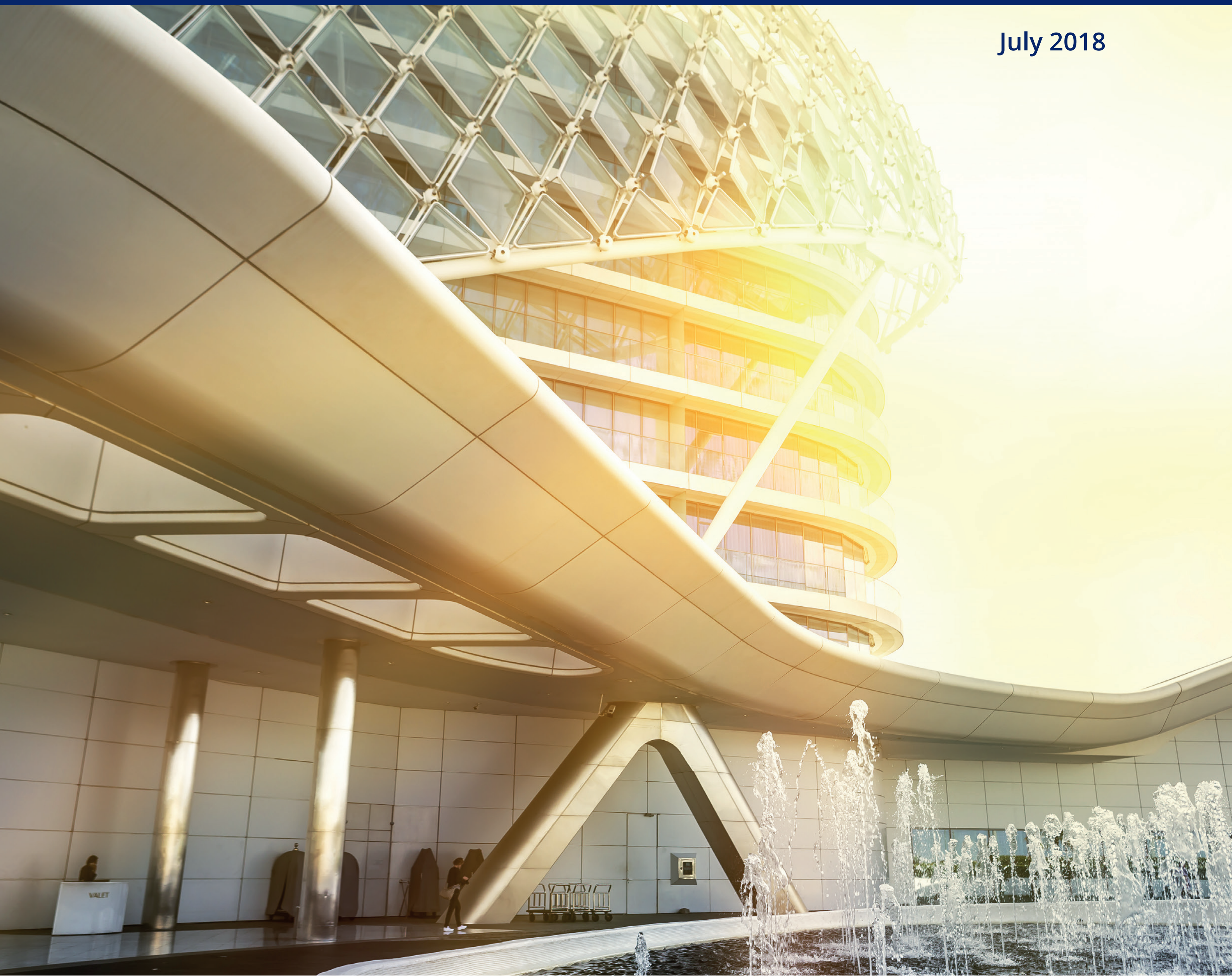
Emerging Market Equities: Index Upgrades and the Middle East

Emirates NBD Asset Management and Jupiter Asset Management

July 2018



Emirates NBD ASSET MANAGEMENT

JUPITER

EM Equities Today

While Emerging Markets (EM) had a strong run in 2017, valuations remain attractive both relative to their own history and to the developed world. Data over a 30-year period shows that if investors purchase EM stocks in the current Price-to-Book (P/B) range of 1.6x to 1.8x, this has typically resulted in an upside of 50% over the subsequent five years (please see chart 1)

But EM equities are no longer at the rock bottom levels we saw in 2016. It has therefore become increasingly important to be selective. Some larger stocks, most notably those that are perceived to be "quality growth companies", are already priced for very strong earnings. This is a good reason for a strategy to be overweight at the small- and mid-cap end of the spectrum, where valuations are more conducive to future strong returns.

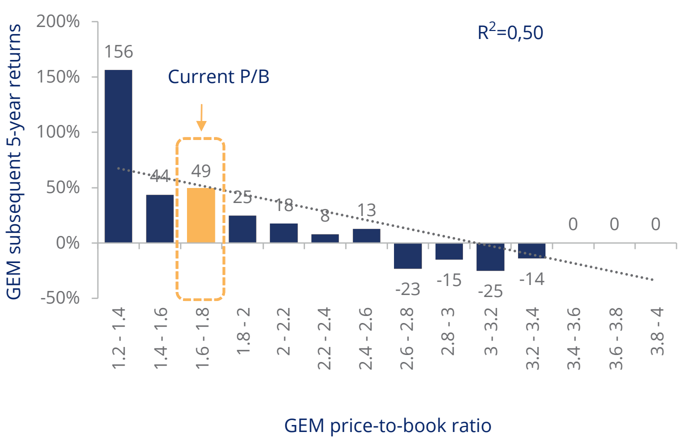
> ***"The fundamental picture for emerging economies is now more robust than it would have been in previous cycles."***

> This year, only 1% of the MSCI Emerging Markets Index by country weighting have a fiscal deficit likely to be over 3% of GDP.

In addition, countries are less reliant on US dollar-denominated debt, with the exception of Turkey and Argentina. As a result, EMs should prove more resilient to interest rate rises and a strong US dollar.

Emerging Markets continue to benefit from long-term tailwinds, such as demographics and rising penetration of products. These positives, against a backdrop of continued earnings growth, make a strong case for emerging and frontier market equities. Political uncertainties are unlikely to dissipate this year, but looking at EMs from the bottom-up, there are plenty of stocks that offer compelling long-term return potential.

Chart 1: Typical 5-year upsides based on P/B values at time of investing



Source: Bank of America Merrill Lynch

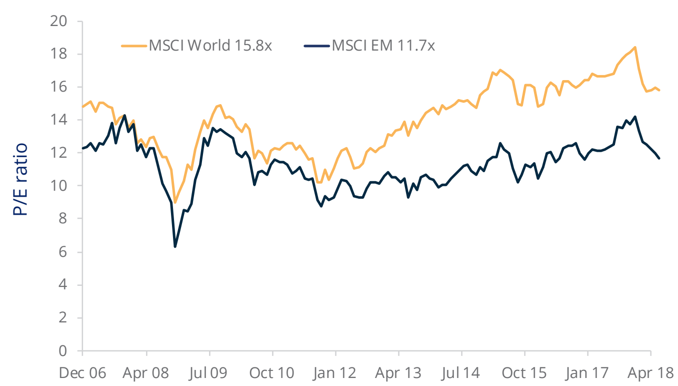
Approaching EM equities

Markets are inherently inefficient when it comes to pricing in change for companies. These changes can be broken down into three categories:

1. A change to the company itself, for example higher margins, resulting from a change in product mix or cost reductions
2. An industry-wide change, such as easing competitive pressures, resulting from a more consolidated sector
3. A long-term structural change, such as rising market penetration for the company's products

This investment style does not fit neatly into a description such as "value", "growth" or even "quality". That's because underappreciated change can be found in any part of the market and in any kind of stock. Another attribute of this approach is that the composition of the benchmark does not influence the way an EM equity portfolio is constructed. Emerging Market indices are skewed towards large-cap companies and have high concentrations in certain countries and sectors, so the opportunity lies in building a portfolio that looks different to the benchmark – for example, by including small- and mid-caps.

P/E Ratios: EM historically cheap relative to developed markets



Source: MSCI, June 2018

Look out for…

Travel and tourism

Rising discretionary incomes across Emerging Markets are giving rise to a greater desire for experience-related activities. Travel is increasing, particularly driven by Chinese tourists. With a population of approximately 1.4 billion, only 6% of Chinese citizens hold passports – approximately 81.4 million people. Compared to the 147 million Americans who hold valid passports, the growth potential is enormous. As international travel grows around the world, spurred by an increase in Chinese arrivals, there are a number of ways to access and exploit this trend.

Stock sample: Emaar Malls

Emaar Malls operates premier shopping facilities in the MENA region, anchored by the recent Fashion Avenue extension at Dubai Mall. Fashion Avenue opened in March 2018 and is home to more than 80 luxury brands from British designers Burberry and Hackett to Russian jeweller Fabergé. To appeal to Chinese tourists, the company created a 'tailor-made' tour of Dubai Mall and Fashion Avenue with Chinese speaking guides. Meanwhile, at government level, the UAE relaxed rules for Chinese tourist visas, which has boosted tourism figures. Emaar Malls trades at a significant discount to historic average multiples and to global mall operators. The discount should begin to close as growth recovers, focusing attention on today's relatively high cap rate of 8.5% and dividend yield of 5.4%.

Financials

When taking a bottom-up approach to portfolio construction, a common thread among EM stocks is the theme of financial inclusion in indigenous populations. Banking penetration is low in markets such as Kenya, Nigeria and Pakistan. Due to the relatively low cost of financing, banks have the potential to make abnormal year-on-year return on equity.

Stock sample: Kenya Commercial Bank

Kenya's mortgage market is starting to take off. In a country with a population of over 44 million, there are only 22,000 mortgages. Kenya Commercial Bank (KCB) is best placed to take advantage of the potential for growth driven by rising financial penetration. KCB operates across six East African countries, but 90% of profits come from Kenyan operations. KCB has a strong deposit franchise and therefore low cost of funds. It is trading on attractive valuations of approximately 1.5x book, which represents a discount to the seven-year average of 1.9x.

Tech enablers

The high valuations of well-known tech giants highlight investor optimism for growth. However, there are many opportunities beyond the obvious mega-cap stocks which show underappreciated potential. Examples include SK Hynix, a south Korean company producing dynamic random-access memory (DRAM). Its chips are used in anything from Apple's laptops to Google-branded tablets to servers used by Chinese internet giants Tencent and Alibaba. The development of electric vehicles is also a driving force. Beyond Tesla, access to the "EV revolution" can be gained through companies such as Chroma and Bizlink. Taiwan-listed specialist engineering company Bizlink are the experts in this technology, providing components known as battery wire harnesses for electric vehicles. The company's expertise is reflected in high-end clients such as McLaren and Tesla.

Stock sample: Chroma ATE

Chroma is a Taiwanese electronics testing solutions firm with a market cap of USD 2.2 billion. It has a long-established core business in power electronics and semiconductor testing, combined with exposure to high-growth cleantech segments, including electric vehicle batteries. The company has strong corporate governance and capital management practices, driven by high levels of management equity ownership. Revenue growth is accelerating on expansion of new product segments, and a growing market for semiconductor testing. The company has consistently delivered a pay-out ratio in excess of 60%. What is in the price? An 18x forecast for 2019 earnings and a 3.8% projected dividend yield. Chroma is under-researched with very few international brokers producing research on its stock.

OPPORTUNITY IN THE MIDDLE EAST

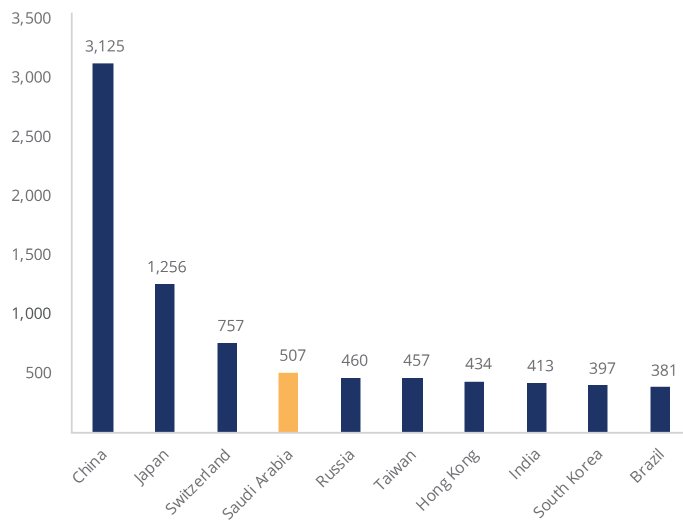
While small- and mid-cap equities should be of interest to EM investors looking to allocate globally, there are a host of opportunities across sectors and cap sizes in the Middle East. Two markets of note today are Saudi Arabia and Egypt, which are both in the process of dramatic economic and structural change.

Why Saudi, and why now?

The first public movie screening and the recent issuance of the first driving licenses to women are just two among a multitude of bold socio-economic changes taking place in the Kingdom of Saudi Arabia. The economic implications are significant. By allowing women to drive, the local workforce rapidly increases in number, harnessing untapped potential and raising productivity. It will, moreover, go some way to stemming leakage of the country's forex reserves through remittances by expatriate workers. The Saudi Arabian Monetary Authority (SAMA) has reported that remittances have fallen from a peak of USD 42 billion in 2015 to USD 38 billion in 2017 – a trend that is expected to continue.

The Kingdom boasts considerable forex reserves which, at USD 506 billion, make them the 4th largest globally. However, they have declined – from USD 750 billion in 2014 – in the wake of an oil price slump that reached a low of USD 30/barrel in 2016. As a result, the Vision 2030 transformation plan seeks to diversify income away from oil revenues, boosting foreign investment and reducing energy subsidies. Once implemented, the country's budget could be balanced with oil prices as low as USD 50-60/

Comparitive Foreign Exchange Reserves (USD billion)



Source: Bloomberg

As forex reserves have declined, the Kingdom has been able to plug this gap with issuance of US dollar-denominated debt, due to its unlevered sovereign balance sheet. While the sovereign could easily issue up to USD 100 billion in foreign debt, maintaining a debt to GDP ratio of 25% and retaining an A1 credit rating, a great deal more can be achieved through its stock market.

> With a market capitalisation of USD 530 billion, Tadawul All Share Index (TASI)) is the 23rd largest in the world and by far the largest in MENA.

The Capital Market Authority (CMA) has been proactive in opening opportunities for foreign participation, with the Qualified Foreign Investor (QFI) programme launched in 2015 and recently revamped to ease access.

But accessibility alone is not sufficient. Investors must be guided by international indices, and that is now the case, with FTSE Russell, and MSCI all confirming Saudi Arabia's status as an EM index constituent. Tadawul is making sweeping structural and technical changes to stimulate foreign inflows, including the introduction of the T+2 settlement cycle, a new custody model and clearing mechanisms aligned with international standards. The efforts of the CMA and Tadawul were rewarded with a 2.5% weighting on the FTSE Russell EM Index announced in March 2018. With MSCI's recent announcement of the Kingdom's inclusion – at a weighting of approximately 2.6% (with 32 securities), it is likely that foreign inflows from active and passive funds will reach USD 45 billion. For those looking to beat the rush, the time is right to allocate to Saudi equities, albeit selectively.

What does an MSCI upgrade really mean?

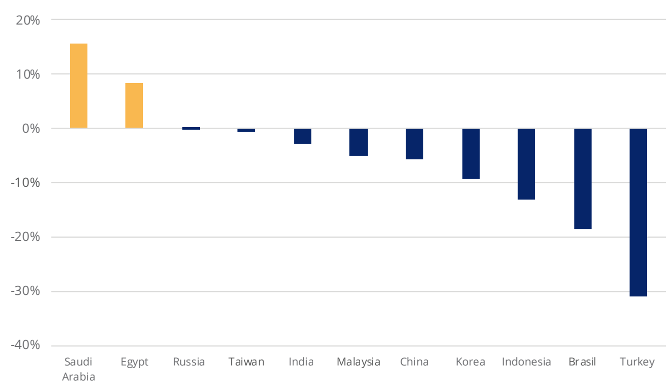
With the recent announcement of Saudi Arabia's inclusion on MSCI's Emerging Market Index, it's worth considering what this really means for the Kingdom's equity market. Firstly, foreign inflows from both active and passive fund managers are set to dramatically increase – to as much as USD 45 billion. But how does the upgrade impact the performance of the market?

In 2014, a similar upgrade was implemented for the UAE and Qatar. In the 12-month period from June 2013, when MSCI announced their upgrade to the Emerging Market Index, the Qatar Stock Exchange, Abu Dhabi Exchange and Dubai Financial Market indices all recorded a phenomenal rally of between 50% to 100%. Prior to the announcement, foreign ownership levels in these markets were already at 10%.

Saudi Arabia sits at the other end of the spectrum. With the upgrade only just announced, the Kingdom's foreign ownership level is at a paltry 2%. Smart fund managers from as far away as the US, UK and Asia have, in anticipation, dipped their toes into Saudi stocks, with foreign inflows amounting to USD 3 billion for the first 5 months of 2018. In context, that is equivalent to all foreign inflows to the UAE and Qatar for the whole of 2014, when these markets were upgraded.

The importance of the upgrade as a catalyst for the Saudi capital market cannot be ignored. In 2018, expectation of the MSCI upgrade has already driven the Tadawul up 15% YTD, in stark contrast to the MSCI Emerging Market Index itself, which is down 2% for the year.

Saudi Arabia and Egypt outperform EM markets in 2018



Source: Bloomberg, USD terms, YTD till 29 June 2018

Egypt: a new dawn?

The structural reforms implemented by Egypt as part of its 2016 agreement with the International Monetary Fund (IMF) have played a key role in stabilizing the economy. In fact, the Egyptian economy is expected to witness a period of relief over the next 12-18 months, as inflation and interest rates start falling. Five factors will provide support for the Egyptian economy in the medium- to long-term.

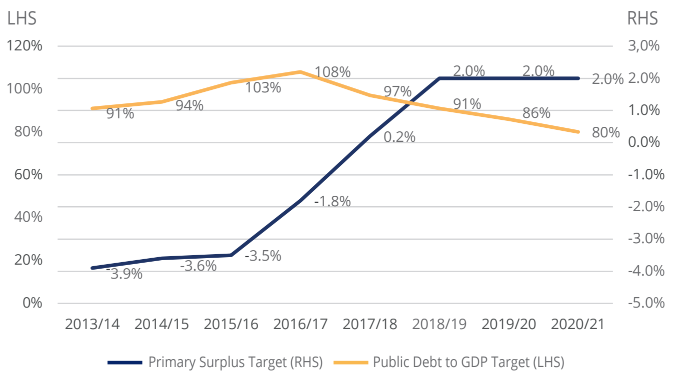
1. **Inflation has started to normalize** after peaking at 33% in July 2017. The EGP devaluation that took place in November 2016 as well as increases to fuel and electricity prices contributed to pushing inflation to record levels in 2017. Inflation declined to 11.4% in May 2018 from 13.1% Y-o-Y in April 2018, registering the lowest level since devaluation.

2. **Lower interest rates should lend support to local equities.** The Central Bank of Egypt has announced cumulative interest rate cuts of 200 basis points since the beginning of 2018. Further rate cuts are expected in 2H2018 under the assumption that inflationary pressures continue to moderate.

3. **The EGP has stabilized** at EGP 17.7/USD YTD in 2018 and continues to be supported by strengthening foreign reserves. FX reserves have, in fact, increased to a new record of USD 44.1 billion in May 2018 supported by a combination of improved tourism activity (up 123.5% Y-o-Y to USD 7.6 billion in 2017; arrivals grew 33% Y-o-Y in 1Q2018 and revenues jumped 83% Y-o-Y), higher FDI and issuance of USD bonds. The government issued a USD 4 billion Eurobond in February in addition to a EUR 2 billion (USD 2.3 billion) Eurobond in April, lending further support to FX reserves.

4. **Strong GDP growth will boost listed companies' earnings.** The Egyptian government has budgeted for a GDP growth target of 5.8% in fiscal year 2018/2019 (ending June 2019). In fact, the IMF expects Egypt's GDP growth to rise to 6% in the medium term (the IMF expects GDP growth of 5.2% in the current fiscal year FY2017/18). The improved macro-economic environment should support the performance of the local stock market as it translates into higher earnings for listed companies.

Egypt: Primary Surplus and Debt-to-GDP Targets



Source: Ministry of Finance

5. **The Zohr field will bring Egypt into gas self-sufficiency.** The Zohr natural gas field started operations in December 2017 with an initial production of 350 million cubic feet per day. Daily production is set to increase to 1 billion cubic feet in June 2018 and is expected to reach 2.7 billion by the end of 2019. This should help Egypt achieve natural gas self-sufficiency and reduce its energy import bill.

ALLOCATION: WHERE, WHY AND WHY NOT

While investment opportunities across MENA abound, it is essential to be selective. To take Saudi Arabia as an example, the Kingdom is undeniably on a more economically sustainable path, but there will be challenges along the way.

> Investors will need to be vigilant in selection of stocks, rather than blindly following international indices.

Where investment in Egypt is concerned, the country has one of the highest growth potentials in the region, where painful reforms are starting to yield healthy results. Falling interest rates have been a strong catalyst for market performance, although in the short-term, reduction of energy subsidies and hiking of fuel prices by up to 50% could temporarily temper the current outlook. The long-term prospects, however, remain positive as the foundations of the economy are strong.

Being selective in the Kingdom

A number of sectors in the Saudi market may at first glance seem attractive, but investors should be selective in their approach. A number of much needed economic reforms may initially inhibit economic growth - for example, the removal of fuel subsidies, the introduction of VAT and levies on expat workers, who may consequently choose to exit the labour market. These macro factors will undoubtedly weigh on equity valuations, another consideration that should be duly understood by investors entering the market for the first time. Longer term, however, we expect reforms to be a very positive driver for the Saudi equity market.

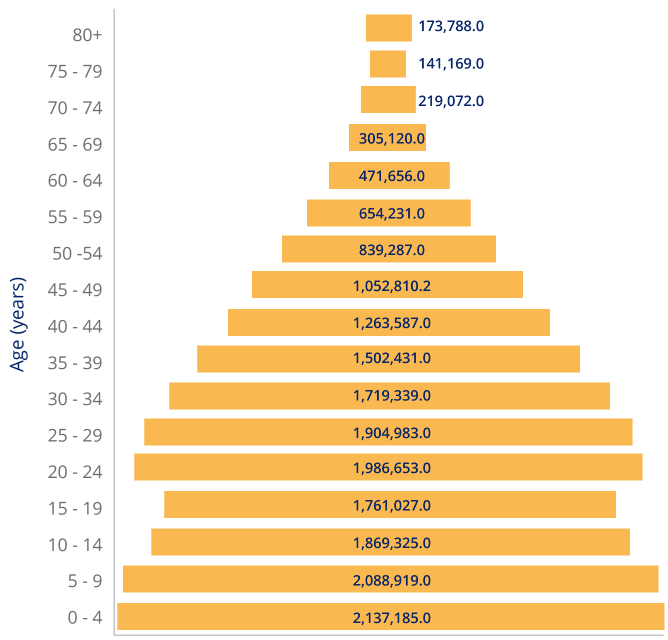
Top targets

After a foothold has been gained in global indices, it is more than likely that a stream of listings for state-owned jewels will ensue, and many of these will hold considerable appeal.

> The listing of Saudi Aramco, a global behemoth, is well-publicised and is slated for 2019. In addition, companies ranging from healthcare, financials, education and defence are likely to seek IPOs.

Trophy assets from Saudi Arabia are expected to be heavily subscribed. The Kingdom's initial EM index weightings will therefore cover a wide spectrum of representation ranging from banks to petrochemicals, healthcare, consumer and insurance. Saudi Arabia boasts world class petrochemical companies such as SABIC and Yanbu Petrochemicals, which will attract a strong following among international investors. Insurance, healthcare and consumer sectors will benefit from the structural changes that are emerging, from the more active participation of the private sector to young population demographics.

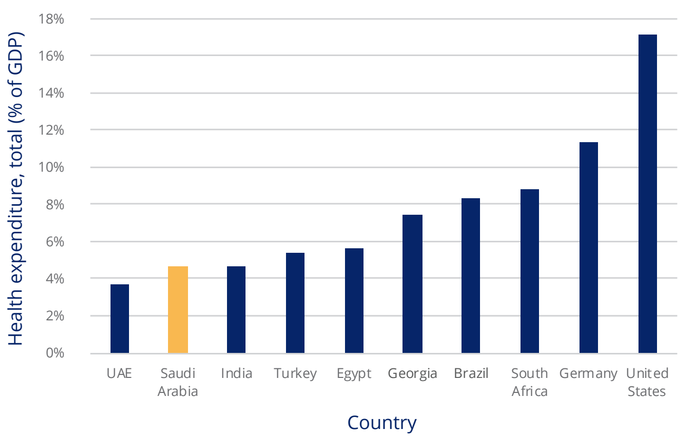
Demographic distribution of non-migrant population in Saudi Arabia



Source: The General Authority for Statistics

The Saudi healthcare sector, in particular, shows a considerable level of underappreciation, and with underappreciation comes opportunity. There are a large number of under-researched, well-run healthcare businesses in the Kingdom that will benefit from structural change. Healthcare spending in Saudi Arabia is set to rise as medical insurance moves from the state to the private sector. Furthermore, the improved availability of high-end services domestically means that some patients who previously travelled overseas for treatment will spend more on healthcare at home. A high incidence of chronic conditions such as diabetes and rising demand for long-term care for elderly patients also suggests structural growth potential for healthcare spending.

Room for improvement: Healthcare spending as a percentage of GDP



Source: The General Authority for Statistics (GAStat), mid-2016 population data, https://www.stats.gov.sa/en/5305

Eyes on Egypt

The outlook for Egyptian equities is positive.

> Since devaluation in November 2016, to-date the EGX30 gained about 80% (40% in USD terms).

Going forward, Egypt may well trade back to its 2014 high, offering potential returns of 40-50% over the next two years.

As the EGP strengthens, companies reliant on imports – for example in the consumer sector – are set to benefit from improved earnings, whereas prior to devaluation exporting companies had taken advantage of a jump in margins from selling in dollars.

Moreover, earnings by companies that are highly leveraged stand to benefit from a falling interest rate environment. But which sectors look most attractive?

Banks will continue to do well, taking excess liquidity by loading up treasuries generating substantial net interest margins (NIMs). Falling interest rates will allow Egyptian banks to channel investments into loans, thereby protecting margins. The consumer sector is also set to benefit from falling interest rates and rising wages, pushing up demand that has sagged in recent years.

Real estate companies will take advantage of falling interest rates, which will improve affordability, considering inherent demand for housing remains strong at 50,000 units per year for "Grade A" properties (vs. an estimated supply of 10,000 units). Meanwhile, industrial companies will attract increased FDI as the next phase of growth, which will see exports kick into full gear.

Stocks to watch include Commercial International Bank Egypt (COMI), which is widely regarded as a solid proxy for the growth of the economy; Ghabbour Auto (AUTO), which will benefit from declining import prices, raising demand and potentially driving higher margins; consumer and real estate companies such as SODIC (OCDI) and Talaat Moustafa Group (TMGH), for whom falling interest rates should stimulate sales.

Investing in Egyptian stocks is not, however, without risk. Rising oil prices are likely to create upside pressure on inflation, which might delay the monetary easing cycle. According to the Ministry of Finance, every USD1/barrel increase in the oil price adds an EGP 4 billion (USD 0.2 billion) burden to the budget. A further sharp devaluation of the EGP will negatively affect USD-based returns, while a potential renewal of political instability and any escalation of geopolitical risk may hamper investor sentiment.

CONCLUSIONS

The MENA region will offer considerable opportunity in 2018-19, and no regional markets are showing greater upside potential than Saudi Arabia and Egypt. With continued earnings growth, increased political stability, and the rising penetration of consumer products, equities of all sizes are set to offer compelling long-term returns.

With normalising inflation, lower interest rates, and a stable EGP, Egypt is capturing the imagination of EM investors. The boost to the bourse's capitalization, with the anticipated stake sales of more than 20 state-owned companies to raise EGP 100 billion (USD 5.7 billion), and economic relief resulting from structural reforms will see the country's equity market grow in both size and liquidity.

In the medium term, Saudi Arabia is probably the most exciting prospect of all. In a market that is already both substantial, and highly liquid by regional standards, the impact of the MSCI upgrade will be profound. Supported by the macroeconomic and structural changes that the Kingdom is undergoing, it has become a truly attractive proposition for the international investment community.

There is a structural story beyond Saudi's MSCI EM upgrade. In the long term, MENA markets could have a 7% weighting in the EM Index. In this scenario, the region becomes too big to ignore for institutional investors.

CONTACT

Emirates NBD Asset Management

Richard Lee

RichardLee@EmiratesNBD.com

+971 4 370 0022

Jupiter Asset Management

Emily Paul

Emily.Paul@jupiteram.com

+44 (0) 20 3817 1495

Media enquiries

George Allen

Instinctif Partners

George.Allen@instinctif.com

+971 55 104 3586

Emirates NBD ASSET MANAGEMENT

JUPITER