Is this the Riyal Deal?

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Charlemagne Capital

Investment Opportunity

Our thesis when examining the investment potential of frontier and smaller emerging markets has always been that political, economic and stockmarket reforms create high levels of economic growth and that the best place to look for companies that can and are likely to compound their earnings over many years is in precisely these reforming markets.

Reform processes are normally born out of necessity and are precipitated by a failing economic regime. The catalyst for economic reform is normally a change of administration, and with many disparate political systems in the world, this can take many forms. This form does not have to be a true democracy as many of us understand it; the most successful example of a long-term growth story in emerging markets has been under the state sponsored capitalism system in China.

What we are witnessing in Saudi Arabia at the moment is quite possibly the beginning of a multi-year reform story with the stated goal of diversifying its economy away from a reliance on oil. The publicly stated intentions of the administration are clearly aligned with this goal, but as we have repeatedly observed in many other countries, this has to be supported by the population who will have to bear the short term negative economic consequences of any reform programme.

By examining the reform process currently occurring in Saudi we can start to determine the mile stones and key trigger points that would move the investment case from one of hope and expectation towards reality. Our well defined process when researching these reform opportunities is predicated on attempting to disaggregate the words of the administration from its actions. Only actual implemented policy changes would cause us to upgrade our investment view.

Political Reform

Firstly on political reform. As I mentioned, reform might not always be manifested in a move towards or an increase in democracy. The key is for the administration to be reformist towards the economy and the stockmarket. A greater level of democracy will generally follow.

The elevation to Crown Prince of Mohammed Bin Salman, the 32 year old son of the king, created a clear path to his succession of power with the strong potential for long term political stability. Creating this clear power structure enables a significant acceleration of other reforms, provided all groups of the population continue to support the goals.

Very significantly, and again historically highly correlated with future economic growth, this political stability has enabled a huge anti-corruption drive, culminating in the “internment” of many of the wealthiest Saudis in the Ritz Carlton hotel in Riyadh. It appears that the ticket to freedom is a repayment of a large percentage of “non-earned” wealth. Whilst providing a much needed windfall to the government in terms of a cash injection there should also be a significant reduction in unearned economic rents going forward. The potential listing on international exchanges of Saudi Aramco is another important step in this process. Whilst the windfall of the sales process will provide breathing space on the still too large budget shortfall, the increased scrutiny and transparency of the state oil sector will reduce the corruption leakages going forwards.

Economic Reform

The first clear indication of significant economic, and by necessity social, reform came with the announcement in 2016 of Vision 2030 which is aimed at increasing non-oil revenues fourfold by 2020 and eightfold by 2030. This Vision has since been articulated in the National Transformation Plan which details sector by sector the reforms that are required to move towards the end of a reliance on oil.

In order to make these reforms viable, significant social reform is taking place as well, with the most high profile change being permitting women to drive from June 2018. This has huge implications for the size of the employable work force and its productivity as well as the ability to increase the tax revenue base. Together with changes in recreational behaviour such as allowing cinemas and pop concerts for the first time, we are seeing real evidence of words and promises being backed up by actions, THE key barometer of change for our process.

When the oil price fell from its USD 100 peak the Saudi budget deficit ballooned to over 15% of GDP, a clearly unsustainable metric. Again the stated plans have been backed up by deeds with significant subsidy removal and cuts to wages and expense allowances for government workers. We expect the deficit to be back below 7% in 2017 based on continued cost cutting and subsidy removal, but aided significantly by a higher

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than expected oil price. A move to a more sustainable long term budget deficit number will then be predicated on the success of the plan to grow the non-oil economy.

Stockmarket Reform

The third pillar of the required reform process is stockmarket reform. Saudi Arabia is starting from the position of having a very large stock market already with turnover close to USD 1bn per day. This makes it significant even in a more developed emerging market context. Ownership of the market by foreign investors is however around 1.5%, compared with approximately 50% for the main emerging market universe. In order to really grow the non-oil economy, significant amounts of private capital will be required and the cheapest form of long term capital for companies is generally equity capital.

A number of very positive steps have already been taken to open up the capital markets to foreigners. It is now possible for some foreign investors to own stocks directly and we expect this will over time be open to all foreigners. Bringing the settlement process into line with international standards and allowing short selling are two other significant recent milestones that seem to be moving Saudi towards MSCI Index inclusion by the end of 2019 at the latest.

Challenges

The evidence presented in this document so far indicates a strong reform agenda with the political will to follow through on promised policies. It is however fair to point out that not all has been plain sailing over the last two years, particularly when it comes to foreign policy. The ongoing war in Yemen shows signs of becoming a frozen conflict or stalemate, the blockading of Qatar does not seem to have produced any positive tangible results and there does not seem to be a clear strategy towards Lebanon which has been destabilised for no obvious gain.

The other significant test that all oil dependant countries go through is the scenario of a rising oil price once more, and whether that allows the administration to pull back from the reform agenda. Russia is the clearest example of a country that is only serious about reform when the oil price is low. The signs are positive so far in Saudi where the recent 50% increase in the oil price from its lows has corresponded with an actual acceleration of reform and anti-corruption actions.

Timing

Based on the three pillars of reform, Saudi Arabia clearly has the potential to become a multi-year opportunity for stock market investors. The question we are grappling with is one of timing. Reducing wages and removing subsidies has an initial very negative impact on disposable incomes, impacting the very companies outside the oil sector that will be the biggest beneficiaries of the long-term growth of the non-oil economy.

The current reform trajectory brings the inflection point for these companies' earnings ever closer and we are constantly refining our forecasts and risk factors to determine the optimum time to increase our exposure.

Dominic Bokor-Ingram
Portfolio Manager Frontier Markets

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Address: 39 St James's Street, London SW1A 1JD

Tel: + 44 (0)20 7518 2100
Fax: + 44 (0)20 7518 2199

Email: marketing@charlemagnecapital.com
Website: www.charlemagnecapital.com