The Financing Role of the Saudi Capital Market
Promising Prospects

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Executive Summary

Saudi Capital Market

Fairly recent history. Saudi Arabia’s capital market traces its roots back to the mid-1930s. However, for the better part of its history, the market was informal and unorganized, with the bulk of the development occurring in the recent decades. Since most entities in the Kingdom are government- or family-owned organizations, finance was never a challenge, given the national account surpluses and the willingness of banks to lend. Bank financing and lines of credit dominated financing channels for both government- and family-owned corporates. As a result, the capital market was never truly considered an alternate mode of financing. However, the oil price shocks of 1973 and 1981 highlighted the need to diversify the Kingdom’s oil-dependent economy and develop an industrial base. To finance industrial development in the Kingdom, the government continued to rely on specialized credit institutions such as Saudi Industrial Development Bank (SIDB) instead of developing the capital market as an alternative channel for financing.

Growing industrialization: The Naissance of capital Markets in KSA

Industrialization in the KSA gathered momentum after 1984, with the fifth development plan emphasizing the need to establish an industrial-based economy. The private sector assumed a greater role as the government recognized that it would need the backing of private companies for non-oil industrial development. However, financing industrial investment through specialized credit institutions such as SIDB proved insufficient as rapid industrialization entailed significant investment in such industrial projects. This highlighted the growing need for efficient mobilization of domestic savings through capital markets to finance industrial growth. Hence, the Kingdom set up a Ministerial Committee in 1984 to formalize and regulate trading on stock exchanges. Furthermore, in order to increase the breadth and depth of the market, in 1997, KSA allowed foreign investors to invest in stock markets through mutual funds. However, development of the capital market in terms of technological infrastructure continued to lag behind due to the absence of a formal trading platform and unregulated broker trading.

Significant Capital Market Development in Current Decade

Since 2001, capital markets have evolved in terms of product sophistication and improved regulatory as well as technical infrastructure. Establishment of Capital Markets Authority (CMA) as an independent market regulator in 2003 and opening up of the market to foreigners in 2008 proved significant milestones in shaping the regulatory infrastructure of the Kingdom’s capital market. CMA, as an independent market watchdog, boosted investor confidence in the Kingdom’s capital market, leading to significant surge in stock market activity. CMA’s focus on market liberalization also paved the way for foreign independent asset management companies and non-banking investment houses to enter in the Kingdom’s capital market. This, in turn, has led to the introduction of innovative products such Exchange Traded Funds (ETFs), and corporate finance products in the country’s capital market.

Despite Banks Dominating, Equities Emerging as Alternate Mode of Financing

Historically banks have been the prime source of financing in Saudi Arabia; it still caters to 82.0% of the Kingdom’s total funding requirement. However, since 2001, the equity market has progressively evolved as an alternative mode of financing. SMEs and private sector entities keen on raising capital have increasingly preferred the equity market, as many of these companies do not enjoy the leverage of easy financing from banks given their relatively smaller size and risk profiles. The growing popularity of equity financing can be gauged from the fact that the total amount raised through the equity route increased to SAR6.6bn in 2008 from SAR10.1bn in 2001. Given the Kingdom’s equity market is still underpenetrated relative to global standards, equity is likely to continue play a major role in rationing the Kingdom’s growing financing requirement. The recent plausible efforts to push liberalization, especially the partial opening up of the market to foreigners, is a key step promoting development of equity market in the country.
Sukuk Fast Emerging as an Attractive Long-Term Source of Financing

Over the last five years, Sukuks have gained significant popularity in the Kingdom. This is attributable to near absence of long-term financing tool and growing proportion of longer duration capital projects launched in the country. Further, the product also draws a larger acceptance due to its compliance with Shariah principles, a key distinguishing feature. Saudi Arabia has hence emerged as the second largest Sukuk market in the GCC after the UAE. However, with regard to the acceptance of Sukuk as a long-term mode of financing, KSA still trails Malaysia, the largest Sukuk market in the world. This is largely due to structural issues such as lack of robust regulatory framework, thin secondary trading and differences in Shariah interpretation. In our view, Saudi authorities need to take collaborative measures to overcome these shortcomings and facilitate development of a robust Sukuk market in the Kingdom.

Other Complex Capital Market Tools Set to Enter KSA Market

Besides traditional modes of financing such as equity and debt (Sukuk), the complex and sophisticated capital market products such as ETFs, equity swaps and REITs (conventional and Islamic) also hold strong promise in the Kingdom. The launch of these products is not only likely to broaden the availability of financing products in country but also help the Kingdom’s capital market to integrate itself with global markets. However, authorities need to overcome several roadblocks to ensure the viability of these products in the Kingdom. This includes increasing investor awareness, establishing regulatory framework and developing technological infrastructure.

Liberalization Efforts Picked Up, Benefiting the Market

Saudi Arabia’s capital markets have largely benefited from the country’s efforts to liberalize since 2003. This improved variables such as market capitalization, volume and value traded. However, Saudi Arabia remains the least open GCC market, given the limits on foreign participation - value of trade by foreign investors in Saudi Arabia was equivalent to just 3.8% of total value traded in 2008 compared to 30–40% in GCC countries. In this regard, the new law passed in August 2008 was a significant step forward. This law allowed foreigners to buy shares listed on KSA bourses by entering into swap agreements with authorized persons, thereby encouraging foreign participation in the Saudi capital market.

KSA has the Potential to Become Regional Financial Hub

Saudi Arabia’s economy is fundamentally strong as reflected in the Kingdom’s oil-generated surpluses and low borrowings. The massive fiscal surpluses amassed over the last five years have helped government pursue aggressive and counter-cyclical fiscal policies to shore up economic activity, and this stance is likely to continue into next year. Also, private sector corporates in KSA are likely to resume their expansion plans which were stalled during the economic slump. Recovery in private sector spending in line with likely improvement in business confidence is expected to cause a surge in the Kingdom’s financing requirement during the period 2010-2012. Also, domestic savings in the Kingdom is expected to pick up as the economy recovers and income levels improve. This, in turn, would encourage individuals to channelize their savings in capital market. To meet the growing financing need and to provide the different investment avenues to the investors, Saudi Arabia needs to develop full spectrum of capital market products. While the steps have already been taken to develop different capital market tools Kingdom needs to address certain product specific challenges.

Policy Reforms, the Need of the Hour

Though KSA has the potential to become the regional financial hub, enhancement of regulations and corporate governance practices is critical for realizing the country’s potential. CMA should focus on broadening the range of listed instruments such as derivatives, swap agreements and structured credit products like mortgage-linked notes to increase the breadth and depth of the market. CMA also needs to focus on allowing greater direct foreign participation to better integrate market with world market.
The Financing Role of the Saudi Capital Market

KSA's capital market is relatively young compared to regional peers. Development of the Saudi capital market has also been slow as most enterprises in the Kingdom are either government- or family-owned, most of which was funded through the State budget. This reduced Kingdoms’ need for financing. However, Saudi Arabia has embraced some carefully calibrated structural and regulatory changes in the recent past, which accelerated development and bolstered the future prospects of the country’s capital markets. The historical development of the Kingdom’s capital market can be categorized into three broad phases: a) Pre-industrialization phase; b) Post industrialization phase (1984-2001); and c) Growth phase (since 2001) that spurred sweeping changes, putting the country’s capital market on the regional map.

Pre-Industrialization Phase: Capital Markets were Highly Informal

The Saudi capital market can trace its roots back to the mid-1930s when Arab Automobile Company was established as the first joint stock company. However, the market remained highly informal until the early 1980s. This could be attributed to the fact that the large government entities that existed—just 14 joint stock companies were operating in the country and most were government-owned—easily financed their development plans through the national account surpluses. The near non-existence of the private sector and the fact that many major businesses in the Kingdom were family owned (and raised development capital through internal accruals) also deferred the development of a vibrant capital market.

After the crash in oil price during 1981-1991 (when oil traded at average USD22 per barrel), the Kingdom’s traditionally oil-dominated economy saw massive budget deficits. This highlighted the Saudi economy’s vulnerability to oil. Consequently, the government realized the importance of diversifying the economy and developing an industrial base. This entailed investment in non-oil industrial projects. The government also started establishing industrial cities to attract investment in the non-oil industrial sector. Consequently, the non-oil industrial sector in the Kingdom started receiving increased government attention after 1975. However, the government still preferred to finance industrial development through specialized credit institutions such as Saudi Industrial Development Bank (SIDB) rather than mobilizing the country’s wealth through capital market development.

Historical Development of Saudi Capital Market

Chart 1: Evolution of KSA Capital Market

Source: AlJazira Capital

Pre-Industrialization Phase: Capital Markets were Highly Informal

14 joint stock companies were operating in the country and most were government-owned—easily financed their development plans through the national account surpluses.

Industrialization in KSA gathered momentum after 1984 with the fifth development plan (1990-95) laying emphasis on the establishment of an industrial based economy. However, as the pace of industrialization accelerated, financing of industrial projects through specialized credit institutions such as SIDB proved insufficient. The government also realized the importance of private sector participation for non-oil industrial development. Rapid privatization and industrialization highlighted the need for efficient mobilization of domestic savings through capital markets to finance industrial growth. Consequently, in its first important capital market development, the government formed a Ministerial Committee in 1984 to formalize and regulate trading on the Saudi stock exchange. The government also realized the importance of foreign institutional capital in boosting the ability of capital markets to fund economic growth. Hence, in 1997, the Saudi Arabian Monetary Agency (SAMA) approved Saudi American Bank’s proposal for a mutual fund of Saudi stocks that could be purchased by foreigners. This opened doors for foreign portfolio investment in Saudi Arabia. Subsequently, foreign investors were allowed to invest in the stock market through KSA mutual funds. Foreign portfolio investment increased volume and other activity in the Saudi capital market.

Nevertheless, despite the entry of foreign portfolio, capital markets in KSA continued to suffer from unregulated broker trading and lack of sufficient technological infrastructure until 2001. The share market traded through an electronic securities information system (ESIS) introduced in 1990. This system was not designed to handle trading in corporate bonds, mutual funds and new investment products. Consequently, the Tadawul Stock Exchange was established in October 2001 with modern infrastructure to facilitate trading, clearing, settlement and provide an efficient secondary market platform for equities. The establishment of Tadawul provided a formal platform for trading of capital market products, thereby enhancing transparency and efficiency.

Capital Market Growing in Breadth and Depth (Since 2001)

The development of the Saudi capital market beyond 2001 is broadly marked by the greater breadth and depth of the equity market, growing product sophistication and improved regulatory as well as technical infrastructure. Capital Market Authority (CMA) was established in 2003 under the aegis of the Capital Market Law (CML) to regulate and supervise the capital market. CMA issues regulations on a number of critical topics such as corporate governance, market conduct, mergers and acquisitions, and issuance of financing tools such as IPOs, Sukus and mutual funds. Hence, establishment of CMA marked a new era of financial liberalization in the Kingdom. CMA also laid down the legal and regulatory framework to open up the Saudi capital market, support the government’s stated goal of privatization, promote greater efficiency and transparency, and increase public participation in financial markets. State-owned Tadawul Exchange was re-incorporated as a joint stock company in March 2007 with a capital of SAR1.2bn (USD320mn) to give the exchange greater autonomy.

With the establishment of CMA, the Saudi capital market gradually started evolving in breadth, depth and complexity even as the financing needs of corporates, particularly SMEs, increased. The number of listed companies increased to 139 in March 2010 from 76 in 2001 as Saudi companies turned to capital markets to fund their future financing needs. This coupled with increasing investor participation expanded Tadawul’s total market capitalization at a CAGR of 34.8% to SAR1.9tn during 2003-2007. Tadawul’s market capitalization declined thereafter to SAR 924.5 bn in 2008 before again rising to SAR 1.2 tn in 2009.
Stock market activity grew uninterruptedly between 2003 and 2007, with trading volume, value, market cap and number of transactions rising significantly. The total trading volume of shares on Tadawul Stock Exchange increased at a CAGR of 11.4% during 2003-09 to 57.3bn at the end of 2009. The total value of shares traded increased at a CAGR of 16.2% over the period 2003-09, while the number of transactions grew 57.5% over the same period. However, on YoY basis, trading volume and value dipped 3.3% and 23.3% during 2008 as the global economic crisis gripped KSA equity markets. The trading volume and value continued to decline during 2009 with a dip of 3.9% and 35.6% respectively as the investors continued to remain cautious in the wake of global economic crisis.

The growing breadth and depth encouraged Saudi authorities to improve the Kingdom’s technological infrastructure. As mentioned earlier, the market traded through ESIS until 2006. This system was not designed to handle formal clearing and settlement procedures efficiently and quickly. Therefore, to ensure efficient clearing and settlement, in 2006, Tadawul entered into an agreement with Nordic operator OMX to upgrade and implement an electronic trading platform. Technological advancement continued with the installation of ‘SMART,’ a market surveillance system, in May 2006. OMX upgraded electronic trading in 2007.
Another important highlight of capital market development in KSA after 2001 was the growing product sophistication. The new Capital Market Law allowed non-banking foreign brokerages, asset managers, and other non-bank financial intermediaries to operate in the Kingdom. This was in line with CMA's objective to promote healthy competition in the Kingdom's asset management industry and increase the range of products offered to investors. The entry of foreign independent investment companies is likely to provide investors with innovative debt products, ETFs, asset management, Islamic finance and corporate finance products.
The Financing Role of the Saudi Capital Market

Bank Lending, the Key Mode of Finance

During the 1980s and 1990s, traditional modes such as bank financing and lines of credit dominated financing channels for corporates. The dominance of bank credit as a financing tool during the 1990s is evident from the fact that the share of bank lending to GDP more than doubled from 13.6% in 1991 to 29.6% in 1999. Bank credit continues to be the most popular financing channel in KSA, catering to approximately 82% of the Kingdom’s total funding requirement.

However, the need for an alternative mode of financing was increasingly felt during the 2000s. Although bank financing is the most popular financing channel in the Kingdom, the role of capital markets as an alternative mode of financing is gathering momentum since 2001. As privatization and industrialization took precedence, Saudi Arabia witnessed a surge in the number of SMEs and private sector entities. These newly established private companies did not enjoy easy financing from banks, which exercised more caution while lending to them because they were relatively smaller and often ventured into businesses that were yet unexplored. Consequently, traditional bank financing was not sufficient to fund the Kingdom’s rapid economic development. In retrospect, the selective lending policy of banks hindered the Kingdom’s economic growth. This highlighted the need to bridge this financing gap through efficient allocation of financial resources and reduce the stress on the country’s banking system. Saudi Arabia also realized the importance of capital markets as an avenue for investment, which, in turn, would encourage savings in the economy.

Capital Market in Saudi Arabia

Bank Lending, the Key Mode of Finance

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Chart 5: Bank credit dominating during 1990s

[Graph showing the dominance of bank credit as a percentage of GDP during 1991 to 1999.]

Source: SAMA, AlJazira Capital

Chart 6: Emergence of equity financing

[Graph showing the emergence of equity financing as a percentage of total funding sources from 2001 to 2009.]

Source: CMA, AlJazira Capital
Also, Need to Bridge the Shortage of Long-Term Financing Tool Was Felt

Historically, the financing needs of the corporates were primarily short-term in nature as their financing need was restricted to meeting the working capital requirement. This is evident from the fact that short-term bank loans accounted for approximately 58.0% (average) of total bank lending in the past five years. However, need for long-term financing in the Kingdom has picked up significantly in the last few years with growing public and private sector investments in the large infrastructure projects. Currently, projects worth more than USD600bn are at the different stage of planning in the Kingdom. Consequently, companies keen on financing these long-term projects face the risk of an asset-liability mismatch on their balance sheet. Capital market tools such as Sukus enhances «liquidity matching» for mega projects that span over several years by providing long-term financing.

The need for long-term financing is likely to be more pressing when the much awaited mortgage law is implemented in KSA. We believe the mortgage finance industry in the Kingdom holds significant potential to grow given the acute shortage of housing in Saudi Arabia. Residential mortgage finance in KSA stands at a dismal at 1%-3% of GDP compared to the mortgage-to-GDP ratios of 66% for the US and 71% for UK markets, respectively. The implementation of new mortgage law will encourage people in the age group of 20-35 years to buy real estate. In our view, mortgage lenders would require borrowing over long term to fulfill their long-term lending activities. This enhances the prospect of capital market tools as alternative long term financing options in Saudi Arabia.

Chart 7: Short term lending dominates the bank lending in Saudi Arabia

Source: SAM, AlJazira Capital
A. Equities: Emerge as Popular Source of Financing Since 2001

As the need for capital market financing in KSA became inevitable, equities emerged as the popular choice of funding amongst corporates. The setting up of Tadawul in 2001 abolished unregulated broker trading in the Kingdom, and lured corporates keen on raising capital to the equity market. Within equities, initial public offerings (IPO) became the popular mode of financing among KSA corporates. The most notable was the USD2.7bn IPO of Saudi Telecom in 2003. Since then, the number of IPOs in KSA has increased steadily. Of the total amount raised through the equity route, more than 50.0% has been raised through IPOs. The number of IPOs approved on Tadawul Exchange increased to 27 in 2007 from just 5 during 2003-2005. However, due to adverse market conditions, only 13 new companies launched their IPOs on Tadawul in 2008. Number of IPOs on Tadawul’s further declined to 11 in 2009 as companies remained concern while taping the capital market. Nonetheless, over the years, the amount raised though public offerings has increased significantly. The total amount raised through IPOs in KSA grew to SAR36.4bn in 2008 from SAR10.2bn in 2003. The number of publicly listed companies on Tadawul now stands at 139 compared to 76 in 2001.

Besides IPOs, rights issues have also been evolving as financing tool among corporates in the last three years. During 2006-2009, the stock market recorded a total of 15 rights issues collectively aggregating SAR35.1bn. Most companies in KSA prefer to adopt the public offering route as it provides a long-term financing option. Also, in case of economies such as Saudi Arabia, equity financing provides a much easier solution considering the Kingdom’s under-developed, immature debt market. However during 2009, the corporates in KSA relied primarily on debt financing rather than equity due to increased volatility in the equity market. Amount raised through IPOs declined 89.3% YoY during 2009 to reach SAR3.9bn.
Equity Market Holds Significant Potential

Though KSA equity markets have grown significantly over the past five years, it is relatively young and lags other emerging markets as well as regional peers. KSA’s market capitalization to GDP ratio stands at approximately 67.0%, well below that of other emerging markets such as India (104%), Egypt (77.0%), Malaysia (146.0%), Qatar (80.0%) and Bahrain (87.0%).

Volume of shares traded on Tadawul averaged 57.3bn in 2009, significantly lower compared to India’s 223.0bn and China’s 1.6trn. Volumes traded in other emerging markets such as Indonesia, Malaysia and Brazil were also higher than KSA’s during 2009. At 134, Tadawul also trails other emerging markets in terms of number of listed companies. India’s National Stock Exchange (NSE) has 1,439 listed companies, while China’s Shanghai Stock Exchange (SSE) has 864. Number of listed companies on the Egyptian stock exchange (324), Malaysian stock exchange (956) and Indonesian stock exchange (402) is also higher than the number of companies listed on Tadawul. This indicates that the KSA equity market is significantly under-penetrated compared to other emerging countries.

At 134, Tadawul also trails other emerging markets in terms of number of listed companies.
We believe the Kingdom’s equity market is poised to grow further considering the recent efforts to push liberalization, especially by partially opening the market to foreigners through equity swap agreement in August 2008. In terms of value traded, foreign investors account for 25-40% of trading activity in non-GCC emerging markets such as India, Malaysia and Brazil. This is at par with their share of trading activity in GCC markets such as Dubai, Qatar and Bahrain (30-40%). In comparison, traded value by foreign investors accounted for meager 3.0% of the total traded value in KSA in 2009. However, the Kingdom’s decision to open equity markets to foreign participation in August 2008 have encouraged greater foreign investment in the Kingdom’s equity market. Removal of restrictions on foreign investors would increase inflow of funds, thereby boosting the market capitalization and depth of Saudi equity markets. This trend is generally observed in countries in the early or mid stages of economic development. A study conducted by World Bank in 1996 showed market liberalization (including opening of the market to foreign investors) tends to have positive impact on variables such as market capitalization, volume and value traded, especially in emerging markets (see table below). The entry of foreign investors would also enhance corporate governance, increase transparency and encourage development of the market’s technical infrastructure.

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<td>Portugal</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Thailand</td>
<td>No impact</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Turkey</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
<tr>
<td>Taiwan</td>
<td>No impact</td>
<td>No impact</td>
<td>Positive</td>
</tr>
<tr>
<td>Venezuela</td>
<td>No impact</td>
<td>Positive</td>
<td>No impact</td>
</tr>
<tr>
<td>Argentina</td>
<td>Positive</td>
<td>Positive</td>
<td>Positive</td>
</tr>
</tbody>
</table>

Source: Capital Control Liberalization and Stock Market Development report of World Bank, AlJazira Capital
B. Sukus: Why Preferred Over Conventional Bonds?

Sukuk, or Islamic debt security, is a Shariah-compliant alternative to bonds. In Saudi Arabia, Sukus are gaining popularity over conventional bonds due to the inherent benefits to both issuers and investors. Unlike conventional bonds, Sukus are backed by physical collateral, and offer investors proportionate ownership of the underlying asset for a pre-defined period. Conventional bonds, on the other hand, merely represent a promise by the issuer to repay the loan to investors. Also, the growing cost of financing due to the tighter lending environment and volatility in equity markets has increased reliance on Sukuk financing. The issuer of a Sukuk provides a financial certificate to investors who are given proportionate ownership of the underlying asset for a pre-defined period. Moreover, unlike conventional bonds, which provide a fixed interest to bond holders, the Sukuk issuer agrees to provide a return to investors in the form of payments, which are linked to the cash flows generated from the underlying asset for which capital is being raised.

How a Sukuk Works?

Sukuk is an Islamic equivalent of conventional bond based on the Shariah principle of prohibition of interest. Sukus must be able to link the returns and cash flows of the financing to the assets purchased; or the returns generated from an asset purchased. Sukus was originally created as an Islamic alternative for raising medium- to long-term debt capital. The structure of Sukus plays an important role as most prospective investors prefer Sukus that are less complex in nature. Ijarah Sukus are the most prominent form of Sukuk. Sukus can be broadly categorized on the basis of structures as:

a) Ijarah Sukus:
This form of Sukuk is based on the Ijarah form of contract, which entails buying equipment and leasing it to a customer. Ijarah-based Sukus are primarily used in project financing. Under Ijarah Sukuk, the owner enters into an asset sale-agreement with the third party or Special Purpose Vehicle (SPV) that funds the purchase. The ownership of the asset is then passed on to the SPV/trustee upon sale. The asset is then leased back to the owners in return of lease payments during the leasing period. The leasing profit is then distributed among investors and the principal amount is paid at maturity. At maturity, the customer purchases the asset from the trustee.

b) Murabahah Sukus:
Murabahah Sukuk entails the sale and purchase of an asset using the cost plus (mark-up) method. It is widely used for short-term financing in trade finance.

c) Mudaraba Sukus:
Mudaraba Sukus are a form of investment Sukuk that entitle their holders to a share in specific projects against which the Sukuk has been issued.

d) Musharaka Sukus:
Musharaka Sukus are similar to Mudaraba Sukus, except that in Musharaka Sukus the party issuing Sukus forms a committee comprising holders of the Sukuk.

e) Istisna Sukus:
Istisna Sukus are issued to raise funds for a long-term project. Sukuk proceeds are then used to pay the contractor/builder to build and deliver the future project.

f) Hybrid Sukus:
Hybrid Sukus are the combination of Istisna, Murabaha and Ijarah Sukuk. However, 51% of the pool in a hybrid Sukuk must comprise tradable Sukuk such as Ijarah Sukuk.
KSA; the Second Largest Sukuk Market in GCC

Sukuk have gained significant popularity as a tool for long-term financing in the Kingdom, especially over the last five years. The value of sukuk issued in KSA increased at a CAGR of 94.4% during 2003-2007 to USD5.7bn; in comparison, the entire GCC region recorded a CAGR of 75.9% over the same period. However, the sukuk market in KSA witnessed some turbulence during 2008 in the wake of the global credit crunch that forced investors to ditch money markets—this move exhausted resources for sukuks as well. Consequently, sukuk issuance in KSA declined 67.2% YoY to USD1.9bn in 2008 before again increasing to USD3.1bn in 2009. However, KSA continues to be the second largest sukuk market in GCC, accounting for 38.8% of total sukuk issued in GCC during 2009. The sukuk market in KSA started showing signs of recovery during 2009 as the investor sentiment revived. Sukuk issuance in KSA reached USD3.1bn during 2009, exceeding the total amount raised during 2008. This was also the second highest in the GCC region after UAE. The most notable sukuk issuances in Saudi Arabia include the USD799.9mn sukuk issued by Saudi Basic Corporation in 2006 and the USD1.3bn Ijarah sukuk Saudi Electricity issued in June 2007.

Chart 14: Sukus gaining popularity in KSA

In terms of issuance by sector, the Oil & Gas sector has dominated the Saudi Sukuk market. The sector accounted for 34.3% of total value of Sukuk issued during 2003-2009. The Power & Utilities sector accounted for 25.7% of total Sukuk issued over the same period.

Chart 15: KSA-second largest market in GCC

The sukuk market in KSA witnessed some turbulence during 2008 in the wake of the global credit crunch that forced investors to ditch money markets.
By type of issuance, corporate sukuks dominate the sukuk market in KSA, accounting for 82.0% of total sukuk issued in the last five years. The value of corporate sukuk issuance in KSA has grown at a CAGR of 116.7% over 2004-2009 to reach USD1.2bn in 2009. Although sukuks are rapidly gaining popularity over conventional bonds, they continue to remain untapped by corporates in the KSA. This is primarily due to an almost inactive secondary market, differences in interpretation of key Shariah issues governing sukuk issuance, lack of transparency, and limited availability of historical trade information. Despite Tadawul's effort to launch new secondary trading platform in July 2009, trading volume continues to be very thin.

Most Sukuk investors in Saudi Arabia include institutional investors. Government and corporates generally prefer to issue Sukuks to institutional investors as retail investors have a very limited understanding of the product. Besides, lack of liquidity due to inactive secondary trading has so far kept retail investors away from the Sukuk market.

### Table 2: Major sukuk issuance in Saudi Arabia over 2003-2009

<table>
<thead>
<tr>
<th>Sukuk name</th>
<th>Subsc. Date</th>
<th>Value (USD mn)</th>
<th>Sector</th>
<th>Structure</th>
<th>Margin</th>
<th>Tenor</th>
</tr>
</thead>
<tbody>
<tr>
<td>SABIC Sukuk</td>
<td>July 2006</td>
<td>799.9</td>
<td>Oil and Gas</td>
<td>Al-Istithmar</td>
<td>3mSIBOR+40bps</td>
<td>20</td>
</tr>
<tr>
<td>Saudi Electricity Co.</td>
<td>July 2007</td>
<td>1,333.20</td>
<td>Power</td>
<td>Ijarah</td>
<td>SIBOR+45bps</td>
<td>20</td>
</tr>
<tr>
<td>Golden Belt 1</td>
<td>May 2007</td>
<td>650</td>
<td>Construction</td>
<td>Manfa’a</td>
<td>6MLIBOR+85bps</td>
<td>5</td>
</tr>
<tr>
<td>Dar Al-Arkan Int. Group</td>
<td>Mar. 2007</td>
<td>600</td>
<td>Real estate</td>
<td>Ijarah</td>
<td>3m LIBOR+200bps</td>
<td>3</td>
</tr>
<tr>
<td>Saudi Binladin Group</td>
<td>Aug. 2008</td>
<td>266.6</td>
<td>Utilities</td>
<td>Modarabah</td>
<td>7.0%</td>
<td>5</td>
</tr>
<tr>
<td>Islamic Dev. Bank</td>
<td>Sep-2009</td>
<td>850</td>
<td>Fin. Services</td>
<td>Al-Wakala Bel-Istithmar</td>
<td>3.2%</td>
<td>5</td>
</tr>
<tr>
<td>Saudi Hollandi Bank</td>
<td>Dec.-2009</td>
<td>193.3</td>
<td>Fin. Services</td>
<td>Modarabah</td>
<td>6mSIBOR+190BPS</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Zawya, AlJazira Capital
Saudi Sukuk Market Trails Malaysia; Huge Scope for Development

Despite significant growth in the Saudi Sukuk market in the last five years, in terms of penetration, it still trails Malaysia, the largest Sukuk market in the world. We chose Malaysia for relative comparison with the Saudi Sukuk market as it is the global hub for Islamic capital market products, including Sukuk. Malaysia has proved to be a ‘centre of excellence’ for modern Islamic capital market products. The success of Islamic capital market in Malaysia is largely driven by better acceptance of Shariah principle in the country given its large Muslim population. Hence, we believe Malaysia’s hugely successful Sukuk market model can be replicated in Saudi Arabia.

Our analysis of penetration of the Sukuk market in Malaysia suggest that Sukuk financing accounts for 5.3% of the total financing in the country compared to just 1.3% in Saudi Arabia. Also, Sukuk financing accounts for 6.0% of Malaysia’s total GDP compared to a meager 0.7% of the Kingdom’s GDP. This implies that the Saudi Sukuk market still holds significant potential for development.

We believe all structural drivers are in place to help the Saudi Arabia Sukuk market realize its true potential.

Lack of Long-Term Financing Avenues

As mentioned earlier, short-term bank lending accounted for approximately 58.0% (average) of total bank lending in the past five years. This indicates a relative lack of long-term financing avenues for the corporate sector in the KSA economy. Currently, long-term projects face the risk of an asset-liability mismatch. We believe the Sukuk market is likely to emerge as alternate mode of long-term financing given that most Sukusks are issued for periods exceeding five years.

Growing Demand for Shariah Compliant Products

One of the major factors driving the demand for Sukuks in KSA is the growing demand for Shariah compliant products. This could be primarily attributed to country’s large Muslim population resulting in increasing acceptance of such products and services.

Difficulty in Raising Funds Through Traditional Sources

As the global credit crunch gradually engulfed the Saudi market, banks tightened lending norms. Banks in KSA are increasingly adopting a conservative stance and selective lending policies. The collapse of the stock market due to the global liquidity squeeze increased volatility and reduced valuations, making IPOs unattractive for corporates planning to raise funds. This, in our view, would increase investor interest in less speculative assets such as Sukuk.

Increasing Regulatory Push

We are encouraged by Saudi Arabia’s proactiveness to improve the regulatory infrastructure governing the Sukuk market. The Saudi government took several initiatives recently to boost the Sukuk market. The most notable initiative is the launch in June 2009 of a new platform for trading of Sukuk, which is likely to improve the speed and cost of trading and promote the process of efficient price discovery, thereby enhancing transparency. The government is also developing a mortgage institution similar to Fannie Mae through the enactment of a new mortgage law. The establishment of Fannie Mae-type institutions will improve access to mortgages and bolster the Kingdom’s debt and Sukuk markets by facilitating purchase of bonds from housing finance companies.
KSA Sukuk Market Continues to Face Several Challenges

Though the Sukuk market in Saudi Arabia is growing fast and holds significant potential for further development, it continues to face certain challenges. These challenges are holding up the overall development of Sukuk market in the Kingdom. Some of the major concerns facing the Saudi Sukuk market are listed below:

**Lack of Secondary Trading**
One of the prime concerns for the Saudi Sukuk market is the lack of liquidity amid thin trading of Sukus in the secondary market. The Kingdom launched a new secondary trading platform in June 2009; however, the Sukus of just two companies (SABIC and Saudi Electricity) are being traded on the platform currently compared to 11 on the Malaysian stock exchange. Lack of liquidity in the secondary market is also discouraging retail investors considering participation in the Kingdom’s Sukuk market. Another factor hampering the secondary trading of Sukus in the Kingdom is the absence of securitization and active market makers which are essential to ensure an efficient price discovery mechanism for Sukus. Volume in the Kingdom’s secondary Sukuk market is also negatively impacted by the current buy and hold strategies practiced by major investors. This could be primarily attributed to the lack of alternative instruments within the Sukuk asset class.

**Need to Set Up Regulatory Framework**
Saudi Arabia needs to set up an adequate and uniform regulatory framework to keep pace with the rapid growth in the sukuk market during the last five years. Another major regulatory hurdle facing the Saudi sukuk market is the difference of opinion among Shariah scholars. Due to various Islamic schools of thought, interpretation and understanding of the law differs between Shariah scholars. This increases the cost and time taken to issue Islamic instruments, including sukuk.

**Lack of Efficient Information Dissemination Mechanisms and Benchmarking**
Sukuk investors are very keen on a central regulatory body to ensure regular dissemination of key information to investors coupled with timely filings of necessary financial information pertaining to Sukus by listed companies. Periodic dissemination of information is key to ensure the transparency in the Kingdom’s Sukuk market. Currently, there is no benchmark (for instance, a Sukuk index) in the Kingdom to track the performance of a Sukuk as is the case with conventional bonds.
Can the Saudi Sukuk Market Replicate the Malaysian Model?

Our analysis of Saudi Arabia’s Sukuk market so far suggests that the country’s Sukuk market holds significant potential to evolve further. However, as mentioned above, the Kingdom’s Sukuk market is exposed to certain structural challenges that need to be addressed before the success of the Malaysian Sukuk market can be replicated. In our view, the following measures could help Saudi Arabia realize its true Sukuk market potential and establish itself on the global Sukuk map:

**Robust Regulatory Framework**

The establishment of a separate and robust regulatory framework for Sukuk would ensure standardization and minimize the difference of opinion among Shariah scholars. For this, coordinated efforts need to be taken by key regulatory bodies such as SAMA, the Finance Ministry and CMA. For instance, Malaysia established the Malaysia International Islamic Financial Centre (MIFC) in August 2006 through collaborative efforts between financial regulatory agencies, including the Central Bank of Malaysia (Bank Negara Malaysia), the Securities Commission (SC), Bursa Malaysia (Kuala Lumpur Stock Exchange) and the Labuan Offshore Financial Services Agency (the regulator for the international center of Labuan), and participation from the Islamic financial industry in Malaysia. MIFC lays down guidelines relating to Sukuk issuance and provides various incentives to international issuers, including granting licenses and tax incentives. Furthermore, the SC has established a centralized Shariah Advisory Council (SAC) to advise on issues related to Sukuk and other Islamic capital market products. This, in turn, ensures that Sukuk issuances comply with Islamic principles. SAC also provides guidance to investors, the government and industry.

**Active Secondary Trading Market**

One of the key components of the success of Sukuk market in Malaysia is the presence of an active secondary market. To encourage secondary trading of Sukuk, KSA needs to encourage the issuance of Sukuks with varied maturities, credit qualities, currencies and risk profiles. This would provide investors various options in the Sukuk market, and encourage retail participation. For instance, the current Sukuk framework in Malaysia allows issuance of both ringgit and non-ringgit Sukuks. Market makers and brokers should also assume greater role in the secondary market for Sukuks. Intermediaries such as brokers, investment bankers, and fund managers could facilitate secondary trading by underwriting and advising on complex Sukuk transactions. Besides, secondary trading in KSA Sukuk market can be enhanced further by upgrading the technological infrastructure similar to Bursa Malaysia. Tadawul’s current electronic Sukuk trading platform should be equipped to handle central order booking, trade reporting and negotiation. The electronic trading platform should ensure the comprehensive dissemination of price, yield and trade.

**A Leading Islamic Finance Center**

The establishment of an Islamic centre of excellence to impart knowledge in the domain of Islamic finance would increase the number of local qualified Shariah experts. Malaysia, for instance, established several academic institutions under the MIFC umbrella to develop Islamic finance talent. These include the Islamic Banking and Finance Institute Malaysia (IBFIM), the International Center for Leadership in Finance (ICLIF), and the Securities Industry Development Corporation (SIDC).
C. SWAP Agreement

A swap agreement is a type of financial derivative wherein two counterparties agree to exchange cash flow generated from particular assets (for example, equity stock) during an agreed period of time. The swap agreement may be based on the performance of the stocks, or bonds, or interest rates, or other securities. Swaps can also be used to hedge certain risks such as interest rate risk, currency risk or to speculate changes in the price of an underlying asset. There are different types of swap agreements such as interest swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. Equity swap is one of the most prominent type of swap agreement.

An equity swap is a special type of swap wherein the underlying asset is a stock, a basket of stocks, or a stock index. The investor does not have to pay any amount up-front, and does not actually own the stock.

Introduction of Equity Swaps in Saudi Arabia

In August 2008, COMA issued a resolution to introduce a regime that would allow non-resident foreign investors to access shares listed and traded on Saudi Stock Exchange (Tadawul) through equity swap agreement with authorized persons. Under the agreement, the foreign investor would pay the full investment amount as a principal at the outset to authorized licensed intermediaries, which, in turn, would purchase the shares of a particular company. At the end of the specified period, the authorized person would sell the shares and transfer the proceeds plus the economic benefit or losses. Other benefits, such as the right to receive dividends, are also transferred to foreign investors.

Chart 20: Saudi equity swap agreement structure

Authorized persons include intermediaries licensed by the CMA, such as Morgan Stanley and HSBC, to carry out security or investment banking activities in the Kingdom. In fact, Morgan Stanley Saudi Arabia (MSSA) was the first authorized company to enter into an equity swap agreement with a non-resident foreign investor for a single stock.
Will Equity Swap Agreements be Successful in Saudi Arabia?

In our view, equity swap agreements can succeed given the fact that the Saudi stock market remained closed to foreign investors until August 2008. The following are the potential benefits of equity swaps agreement in Saudi Arabia:

It is likely to provide foreign investors a platform to access the Saudi stock market, the largest bourse in the Arab world in terms of market capitalization. The swap agreement would send a strong signal highlighting the Kingdom's openness to foreign investments and motivate foreign investors to enter the Saudi stock market. Foreign investors are also expected to be encouraged by the decision to impose no tax liability on capital gains. While no capital gain tax is levied under the swap agreement, a low tax rate of 5% is imposed on dividend payouts. This compares favorably with other emerging and developed markets (Please refer to Table 3 below).

The swap agreement would help increase the depth and market efficiency as both short term and long term agreements would allow greater role to institutional investors in the Saudi capital market which is currently dominated by retail investors.

The equity swap agreement would encourage international broking and investment house to carry out more researches on Saudi stocks, which, in turn would help investors understand the fair values of the stocks.

Table 3: Saudi Arabia has low dividend pay-out tax with no capital gain tax imposed

<table>
<thead>
<tr>
<th>Country</th>
<th>Capital gain tax</th>
<th>Dividend pay-out tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>NO</td>
<td>5%</td>
</tr>
<tr>
<td>India</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>China</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5%</td>
<td>N/A</td>
</tr>
<tr>
<td>US</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>UK</td>
<td>18%</td>
<td>10%</td>
</tr>
<tr>
<td>Japan</td>
<td>25%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Respective capital market authorities, AlJazira Capital

Although interest in the Saudi equity swap agreement has remained muted so far, it has been gradually picking up. This is evident from the fact that the value of foreign swap purchases grew to USD275mn at the end of January 2010 compared to USD45mn in October 2008. Going forward, we expect interest in equity swap agreements to pick up as clarity on the law improves.
CMA Needs To Take Proactive Measures To Ensure Success Of Equity Swaps

Though foreign interest in the Saudi stock market has picked up with the introduction of equity swap agreements, CMA needs to take concrete steps to overcome potential loopholes in the law.

Recourse to Foreign Investors
The current equity swap regulation provides voting rights to authorized persons rather than to foreign investors. Foreign investors are restricted from participating actively in the affairs of the companies they invest in. Hence, one of the major drawbacks of the current swap agreement is that it does not confer ownership rights to foreign investors. In our view, the swap agreement should provide some recourse to foreign investors in case the authorized persons default on their obligations. This would reduce the counterparty default risk for foreign investors and encourage their participation.

Ensure Long-Term Participation of Foreign Investors
Under current regulation, CMA restricts investment in Tadawul-listed shares by foreign investors to a maximum of four years. This implies that foreign investors are not expected to hold stake in the long term. This could possibly encourage foreign investors to use swap agreements for short- to medium-term trade purposes. This coupled with low percentage of free float on Tadawul could increase volatility in the market. Hence, steps must be taken to ensure long-term participation of foreign investors in Saudi stocks.

Adherence to Regulation
An effective mechanism should be in place to ensure that authorized persons comply with terms and conditions of the swap agreement. This includes adhering to anti-money laundering law, periodic reporting of necessary details such as beneficiary’s name, country of origin, underlying shares and quantity.

Keeping Investors Informed
CMA should take necessary measures to keep foreign investors informed in case of any material change in the law and its potential implications. For this, regular training sessions need to be conducted to provide more clarity to foreign investors.
The Financing Role of the Saudi Capital Market

D. Exchange Traded Fund (ETF)

An ETF is a tradable open-ended fund, or unit investment trust, that invests in a basket of assets such as stocks, bonds, commodities, or other securities. ETF represents proportionate ownership in the underlying securities in an index, and trades at the net asset value (NAV) of the underlying securities. Most ETFs track the performance of benchmarks indices such as the S&P 500. ETFs are in many ways similar to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on a securities exchange through a broker-dealer. As for Saudi Arabia, the general guidelines on the working of ETFs are now available. However, we expect to see more guidelines regarding foreign investment in such products.

Islamic ETFs are similar to conventional ETF and share common characteristics. The major difference between a conventional ETF and Islamic ETF is the benchmark index that the Islamic ETF tracks. An Islamic ETF tracks the benchmark index comprising securities that are Shariah-compliant. Also, under Islamic ETF, a Shariah advisor is appointed to ensure that the ETF adheres to Shariah investment policies and guidelines. Securities that constitute Islamic indices are monitored on quarterly basis.

How an ETF works?

Under an ETF transaction, a separate ETF fund sponsor company files the plan with the regulator, designs the portfolio, and obtains necessary regulatory approval to carry out ETF transaction. Authorized Participants (AP, or market makers) then enter into a ‘participant agreement’ with ETF fund sponsor company and surrender already owned stock basket or cash in return for ETF shares. ETF sponsor company delivers the ETF units comprising 50,000 shares or its multiple. After receiving the ETF certificates, APs trades them on the stock exchange. Potential buyers and sellers then exchange these ETF certificates from the exchange in return for cash.

The most popular types of ETFs are listed below:

1. **Index ETF**: An index ETF is a fund that tracks the performance of a stock market index by holding in its portfolio either the constituents of the index or a representative sample of securities in the index.

2. **Commodity ETF**: A commodity ETF is a fund that invests in commodities such as gold, silver and crude oil. A commodity ETF tracks performance against non-securities indices.

3. **Bond ETF**: Bond ETF is a fund that invests in government bonds. The performance of bond ETFs generally mirrors the broader economic conditions.

4. **Currency ETF**: A currency ETF tracks performance against major currencies such as the US dollar, Euro, and Japanese Yen.
Global ETF Market has Witnessed Significant Growth in the Last Five Years

The global ETF industry has registered phenomenal growth over the last five years. The industry’s total assets expanded at a CAGR of 27.4% over the period 2003-2008 to reach USD700bn by the end of 2008. The total number of ETFs more than doubled to 1,589 in the two-year period ending 2008. The rising popularity of ETFs could be attributed to the several inherent benefits it offers:

**Diversification**

One of the major advantages of ETFs is that they allow investors to invest in a basket of securities or assets, thereby providing the benefit of diversification.

**Liquidity**

ETFs are extremely liquid as they are actively traded on the exchange like stocks. In addition, they are actively managed and have transparent portfolios.

**Tax Efficiency**

Since no underlying securities are sold and they typically have low turnover of their portfolio securities, ETFs attract low capital gain tax.

**Flexibility**

ETFs can be bought or sold at current market price during the trading day, unlike mutual fund, which, in turn offers flexibility to investors.

The current ETF market is primarily concentrated in the US and European countries. As of July 2009, the US accounted for 67.4% of the total ETF market (in terms of assets) followed by Europe with 21.2%. The size of the ETF market in the US and Europe stood USD581bn and USD183bn, respectively, as of July 2009. However, in terms of number of ETFs, Europe has witnessed higher growth (219 new launches during 2008). The total number of ETFs in Europe increased 49.0% YoY in 2008 compared to 16% in the US during 2008. Japan’s ETF market also grew significantly with 46 new launches during 2008. The total number of ETFs in Asia (excluding Japan) grew 37.7% YoY during 2008.

Chart 22: Growth in global ETF market (2003-2009*)

![Chart 22: Growth in global ETF market (2003-2009*)](chart)

The US dominates the global ETF market in terms of assets held

Chart 23: The US dominates the global ETF market in terms of assets held

![Chart 23: The US dominates the global ETF market in terms of assets held](chart)
ETFs Enter KSA Market; Holds Potential

Although the current ETF market is primarily concentrated in the US and European countries, markets in the Middle East are also set to enter the fray with Dubai taking the lead. Nasdaq Dubai and World Gold Council launched the first gold ETF in Dubai in March 2009. National Bank of Abu Dhabi launched Middle East’s first ETF on Abu Dhabi Securities Exchange in March 2010. Other countries in the Arab world such as Saudi Arabia are also increasingly considering to develop Islamic ETF market after Malaysia successfully launched Asia’s first Shariah-compliant ETF in January 2008. In fact, CMA has already approved the listing of Kingdoms’ first ETF, Falcom Saudi Equity ETF by Falcom Financial Services.

We believe the Middle East ETF market, especially Islamic ETF, is still in the nascent stage and holds tremendous potential in countries such as Saudi Arabia. Our optimism is primarily driven by the factors listed below:

- The need for new and innovative products is increasing as Saudi Arabia increasingly seeks to integrate its capital market after opening up the market to foreigners. The introduction of new products such as ETFs is likely to bolster the Kingdom’s image as a regional financial hub.

- Saudi retail investors are increasingly looking at products such as Islamic ETFs to diversify their portfolios after the recent crash in the stock market following the global credit crisis.

- Saudi Arabia’s large Muslim population, sound macroeconomic fundamentals coupled with oil-generated surpluses and low borrowings makes the Kingdom an attractive destination for asset managers keen on foraying into the Islamic ETF market.

ETF market in KSA Needs to Overcome Several Hurdles

Educating Investors

One major hurdle for the ETF market in Saudi Arabia is the limited understanding of the ETF concept. ETF is a complex product and hence investors, especially retail investors, require greater understanding of its functionality. For this, CMA and stock exchange should jointly strive to educate investors by conducting regular training sessions to elaborate how ETFs work and highlight the potential benefits.

Ensuring Active Participation of Market Makers

The ETF market in KSA is still in the early stages of evolution and could suffer from lack of market breadth and depth due to low market capitalization and weak liquidity. In our view, CMA should establish a strong regime that encourages more market makers to participate in the Kingdom’s ETF market. Active participation by market makers such as brokers, investment bankers and fund managers would encourage liquidity and reduce the trading cost for investors due to healthy competition between market makers.

Establishment of Regulatory Framework

Authorities need to establish separate regulatory framework for ETFs in Saudi Arabia as several parties are involved in an ETF transaction. Establishment of robust regulations for ETFs would safeguard investors’ interests and define the roles of all parties involved.

Upgrading Technological Infrastructure

Necessary steps should be taken to upgrade the technological platform and ensure that systematic settlement and clearing systems are in place. For this, Tadawul can enter into partnerships with major exchanges that have already successfully implemented trading of ETFs.
E. Real Estate Investment Trusts (REITs)

REIT is an investment trust in which investor funds are collectively pooled and invested in income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses. REITs generally make investments by buying, managing, selling and leasing of real estate, or purchasing shares in publicly listed real property companies, or investing in debt securities in real property companies. REITs can be publicly traded on stock exchanges just like common stocks or privately held. REIT funds periodically distribute 90% of their net income to investors, and this may be taxable. In Saudi Arabia, according to CMA guidelines, REIT funds shall distribute the funds’ gain to unit holders every six months at a maximum, provided those gains reach certain percentage of the fund's total asset value. However, there are no publicly traded REITs yet in the kingdom. We believe it developing the regulations to allow the listing of REITs in the Saudi Exchange will add more value to customers and enhance institutional investing.

Islamic REITs are similar to conventional REITs in terms of structure and operation. They are also similar in as far as generating returns from the property and distributions are concerned. Furthermore, the regulatory framework is similar with the exception that Islamic REITs must comply with Shariah principles. Islamic REITs are also required to appoint a Shariah Advisor, or Committee, to act as advisor. Islamic REITs must also ensure that income is generated from Shariah-compliant activities and that tenants of the properties undertake activities that are in compliance with Shariah principles.

How an REIT works?
The process begins with a management company inviting investors to purchase REIT units. The REIT invests the amount collectively pooled by investors in income-generating real estate. REITs distribute cash flows periodically in the form of dividends or rental income to investors. REITs also appoint a property manager to manage properties under the fund in return for management fees. The trustee takes custody and controls the fund’s property besides monitoring operations to ensure that unit holders’ interests are upheld.

Chart 24: REIT transaction structure

The most popular types of REITs are listed below:
- a) Equity REITs: Equity REITs primarily own and operate income-generating real estate.
- b) Mortgage REITs: Mortgage REITs lend money to real estate owners and operators or extend credit through acquisition of loans or mortgage-backed securities.
- c) Hybrid REITs: Hybrid REITs own properties besides extending loans to real estate owners and operators.

Table 4: Difference between Islamic and conventional REITs

<table>
<thead>
<tr>
<th></th>
<th>Conventional REITs</th>
<th>Islamic REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shariah committee/</td>
<td>Shariah committee/advisor is not required</td>
<td>Need to appoint Shariah committee/advisor to ensure</td>
</tr>
<tr>
<td>advisor</td>
<td></td>
<td>compliance with Shariah law</td>
</tr>
<tr>
<td>Permissible activities</td>
<td>No restriction</td>
<td>Only activities permissible under Shariah law</td>
</tr>
<tr>
<td>by tenants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance for properties</td>
<td>Conventional insurance with insurance companies as</td>
<td>The manager needs to consider the availability of</td>
</tr>
<tr>
<td></td>
<td>approved by trustee</td>
<td>Insurance Islamic/ Takaful before opting for</td>
</tr>
<tr>
<td></td>
<td></td>
<td>conventional insurance</td>
</tr>
<tr>
<td>Financing</td>
<td>No restriction</td>
<td>Financing should be as per Shariah law</td>
</tr>
</tbody>
</table>

Source: AlJazira Capital
Global REIT Market Has Evolved Rapidly

The global REIT industry has grown significantly in the last decade, with the free float market capitalization of listed REITs reaching approximately USD800bn by the end of 2007 compared to USD300bn during 1999. This was primarily led by the boom in the real estate sector in European and Asian countries, which experienced a rapid economic boom during the period 1999-2007. During the 1990s, the growth in the global REIT market was largely driven by the boom in the US REIT market. However, the global financial turmoil led by the US sub-prime crisis since 2H 08 severely impacted real estate markets across the world. Consequently, the free market capitalization of listed REITs tumbled to USD380bn by June 2009. Nevertheless, the popularity of REITs has increased significantly due to various factors. Some of these are listed below:

Stable Returns; Low Taxability
REITs are required to distribute 90% of their taxable income to shareholders. Also, dividends are paid from relatively stable and predictable stream of rent cash flows paid by tenants who occupy the REIT property. This ensures income stability. REITs also reduce or eliminate corporate tax altogether since most of the taxable income is distributed to shareholders.

Expert Management And Liquidity
Unlike mutual funds, REITs are extremely liquid as they are actively traded on the exchange like common stocks. Also, REIT properties are managed by skilled, experienced and professional real estate managers. REITs also have low correlation with assets such as equities and bonds that can improve portfolio diversification.

Diversification
REITs enable investors to benefit from diversification as they typically invest in different types of properties, including residential, commercial office, warehouse and hotels. It also enables investors to directly own real estate properties with limited investment.

Hedge Against Inflation
REITs provide a hedge against inflation as real estate prices rise in tandem with prices in the overall economy.

The REIT market in the US and Australia accounts for 47.4% and 12.2%, respectively, of the global REIT free float market capitalization. However, REITs have gained significant popularity in Asian countries (primarily Japan) in the last couple of years. This can be gauged from the fact that Japan’s share of free float market capitalization increased from 5.7% in 2008 to 7.5% in June 2009. REITs are also gaining popularity in other Asian countries such as Hong Kong, Singapore, and Malaysia—the last two are emerging bastions of Islamic REITs, which are gaining popularity in these countries. While Malaysia has two listed REITs, Singapore has just one trading on the local stock exchange.

Islamic REITs Hold Potential in Saudi Arabia

After gaining popularity in Asian countries such as Japan, Singapore and Malaysia during the last five years, REITs are set to gain foothold in GCC countries, especially Saudi Arabia given the significant potential for Islamic REITs in the Kingdom. The trend for Islamic REITs was set in May 2006 when Malaysia launched the IPO of the first-ever Islamic REIT. Within the GCC region, KSA, which facilitated the launch of region’s first Islamic REIT leads the way. The Islamic REIT market in Saudi Arabia is still in the early stages of development but holds significant potential, in our view. Our theory is supported by several factors:

Strong Real Estate Sector Fundamentals
Despite the recent downturn, the long-term fundamentals of KSA’s real estate sector continue to remain intact. Our optimism is largely driven by factors such as the country’s favorable demographic profile, economic diversification, expected implementation of the new mortgage law and sound macroeconomic fundamentals.
Increasing Acceptance of Shariah Products
Shariah-compliant products have been gaining popularity in Saudi Arabia due to country’s large Muslim population, which is very receptive to such products and services.

Appetite for Stable Return
The recent stock market crash increased retail investors’ appetite for stable returns. Products such as REITs could benefit from this as they provide stable returns with the benefit of diversification.

The Potential of the Islamic REIT Market in Ksa Should be Enhanced Through Concrete Steps Such As:

Establishing Universal Islamic REIT Guidelines
Currently, there is no standard regulatory framework for Islamic REITs in Saudi Arabia. The establishment of a standard regulatory framework for Islamic REITs would facilitate differentiation of properties where non-permissible activities (as per Shariah law) are being carried out. For instance, in November 2005, the Malaysian government, through the Securities Commission of Malaysia, issued separate guidelines for Islamic REITs. Currently, Malaysia is the only country to establish such guidelines for Islamic REITs.

Cross Border Trading
The capital market authority should promote cross-border trading of REITs. This will increase the number of investment avenues available to investors, promote foreign participation, and boost liquidity.

Enhancing Secondary Market
Saudi Arabia needs to develop the secondary market for Islamic instruments, including REITs.

SWOT Analysis of Islamic REIT Market in Saudi Arabia

Strength:
Growing acceptance of Shariah-compliant products in the Kingdom
Long-term fundamentals of the Kingdom’s real estate sector are intact

Weakness:
Absence of universal Islamic REIT guidelines
Absence of secondary trading and liquidity
Limited understanding of the product, especially among retail investors

Opportunities:
Growing appetite for stable returns among retail investors
Increasing presence of international broking and asset management companies to improve liquidity in the market

Threats:
The Saudi Islamic REIT market faces stiff competition from Bahrain and Dubai
Limited participation by foreign investors
F. Special Purpose Vehicles (SPVs)

A Special Purpose Vehicle (SPV) is a separate legal entity created to fulfill specified objectives such as asset acquisition, project financing, leasing and securitization. They are usually created to facilitate investment in, and management of, a specific project. For instance, a group of private investors may form an SPV to bid for an infrastructure contract and operate the infrastructure. The SPV might be jointly owned by a public entity and private investors. SPVs are generally created as subsidiaries but sometimes also as partnerships, trusts, or other forms of unincorporated structures. An ideal SPV should be able to operate independent of its sponsoring company.

SPVs in Saudi Arabia Set to Gain Traction

Historically, SPVs are popularly used for complex derivatives transactions in the U.S. and European countries. As for Gulf countries, SPVs are a relatively new concept. However, SPVs are now gaining popularity in countries such as Dubai, and are primarily relied upon for project financing, structured finance products, and asset acquisition. SPVs have the potential to be successful in Saudi Arabia as well due to several factors such as:

Growing Demand For Securitization And Structured Finance Products

Demand for structured finance products such as residential mortgage-backed securities (RMBS)/Sukuk is likely to grow with the implementation of the new mortgage law in the wake of the housing shortage in the Kingdom. The government is already developing a mortgage institution similar to Fannie Mae in the US through the mortgage law. This, in turn, would encourage the setting up of SPVs in the Kingdom.

Lucrative Project Financing Market

The need for project financing in Saudi Arabia has grown with projects worth more than USD600bn at different stages of planning. The concept of SPV is likely to gain popularity as both public and private sector companies in KSA use SPVs to legally isolate a high-risk project/asset from the parent company and allow other investors to share the risk.

Saudi Arabia Needs to Address Certain Issues to Ensure the Success of SPVs in the Country

SPVs have the potential to grow in Saudi Arabia, especially if supported by the establishment of stringent regulations. For instance, Dubai International Financial Centre Authority (DIFCA) recently passed legislation for the creation of SPVs that are vital for structured finance transactions. The Kingdom needs to encourage establishment of SPVs backed by government funding for real estate and construction sector projects. This would ease liquidity in the construction and real estate sectors and enable developers to offload completed or under-construction illiquid properties to SPVs. These SPVs should have the capacity to hold illiquid assets for at least two to three years.
Regulations Governing Capital Markets

KSA Has Suffered From Lack Of A Robust Regulatory Framework

Historically, capital markets in Saudi Arabia have suffered due to the absence of an adequate and robust regulatory framework. Until 2001, trading on the Saudi stock exchange suffered from absence of a formal trading, clearing and settlement platform. However, establishment of the Tadawul in October 2001 with modern infrastructure provided the much needed physical market place for trading, clearing and settlement of capital market transactions. In 2007, the Council of Ministers converted Tadawul into a state-owned joint stock company. The move was aimed at strengthening the capital market regulatory framework by providing more autonomy to Tadawul.

Establishment of CMA Vital for Regulatory Infrastructure

Until 2003, SAMA was entrusted the responsibility of regulating and monitoring capital market activities. However, the establishment of CMA under the Capital Market Law in July 2003 proved a key milestone in shaping the regulatory regime of capital markets in KSA. CMA was established as an independent authority to regulate and supervise the capital market. CMA is the sole regulator and supervisor of the capital market. It issues rules and regulations to protect investors and ensure fairness and efficiency in the market. CMA has formulated regulations on a number of critical issues such as corporate governance, market conduct, mergers and acquisitions, and laws that facilitate introduction and application of financing tools such as IPOs, Sukuks and mutual funds. The key functions and responsibilities of the CMA are:

- Regulating and monitoring issuance of, and trading in, securities
- Authorizing market intermediaries
- Enforcing corporate governance, transparency and other norms
- Promoting education of investors and issuers
- Developing procedures that mitigate risks associated with securities transactions
- Reviewing interim and annual financial statements of listed companies and monitoring their publication on the Tadawul website.

CMA carries out these functions through its departments: Research and Investor Awareness, Authorization and Inspection, Market Supervision, Corporate Finance, General Administration and Enforcement.

However, evolution of the regulatory framework in KSA has been slower relative to that in GCC and other emerging markets. The following table shows that while major emerging countries such as India, China, Malaysia, Indonesia and Egypt established independent regulatory bodies to govern their capital markets in the early 1990s, KSA waited until 2003. This delay impeded the growth of capital markets in KSA vis-à-vis its peers.

Table 5: Difference between Islamic and conventional REITs

<table>
<thead>
<tr>
<th>Country</th>
<th>Market regulator</th>
<th>Year of establishment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>Capital Market Authority of Saudi Arabia</td>
<td>2003</td>
</tr>
<tr>
<td>UAE</td>
<td>Securities and Commodities Authority</td>
<td>2000</td>
</tr>
<tr>
<td>Oman</td>
<td>Capital market Authority</td>
<td>1998</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Capital Market Supervision Directorate</td>
<td>2002</td>
</tr>
<tr>
<td>Egypt</td>
<td>Capital Market Authority of Egypt</td>
<td>1979</td>
</tr>
<tr>
<td>India</td>
<td>Securities and Exchange Board of India</td>
<td>1992</td>
</tr>
<tr>
<td>China</td>
<td>China Securities Regulatory Commission</td>
<td>1992</td>
</tr>
<tr>
<td>Russia</td>
<td>Federal Financial Market Services</td>
<td>2004</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Securities Commission</td>
<td>1993</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Capital Market Supervisory Agency</td>
<td>1995</td>
</tr>
</tbody>
</table>

Source: AlJazira Capital
The Financing Role of the Saudi Capital Market

Key Recent Regulatory Reforms Governing Capital Markets

In the last few years, CMA has enacted several key reforms that have played an important role in the development of capital markets in KSA. Between 2004 and 2008, CMA issued several regulations governing offers of securities in the Kingdom, including public offering (IPO, Sukuk issuance, mutual funds, etc), listing and private placements. In 2006, CMA issued several significant regulations pertaining to market operations such as the Real Estate Investment Funds Regulations and Corporate Governance Regulations. A regulation for mutual funds and another for mergers and takeover operations will be issued soon. Key recent regulations implemented by CMA are listed below.

Encouraging Participation of GCC Nationals

Prior to 2007, GCC nationals in Saudi Arabia were not given complete freedom for equity participation. Their participation was restricted to investment in certain stocks. GCC nationals in KSA were not allowed to own stocks of banking, real estate and insurance companies. However, in 2007, CMA gave GCC nationals complete liberty to invest in KSA stocks. The new law issued by CMA permitted equal treatment in share ownership and trading on the Saudi stock market to Saudi nationals and citizens from the other five GCC countries. The move improved liquidity and breadth in the Saudi equity market.

Money laundering and Counter-Terrorist Financing Rules

In December 2008, CMA issued new rules to counter money laundering and funding of terrorism. This was in line with CMA's objective of ensuring full compliance by licensed and registered bodies against money laundering and funding of terrorism. It also aims to enhance the integrity and credibility of the Kingdom's financial market and protect licensed bodies and their clients from illegal operations that involve money laundering, funding of terrorist activities, or any other illegal activity.

Opening Market for Foreign Participation, a Landmark Development

Until August 2008, trading on Tadawul was characterized by lack of foreign participation. Tadawul was largely closed to foreign capital as foreign investors were only allowed to invest in the stock market through KSA mutual funds. This could be ascribed to KSA government's apprehension that speculation and outflow of hot money would increase with the entry of foreign capital. Speculation and outflow of hot money played a key role in destabilizing East-Asian economies and their currencies, especially the Thai Baht, during the 1997 Asian crisis. However, the Saudi government realized the importance of foreign capital for the country's economic growth (as is the case with emerging countries) and the need to integrate capital markets with international capital markets. Consequently, CMA implemented a new law in August 2008 that could prove to be a landmark development in the overall capital market development of KSA. Under the new law, CMA announced that it would allow foreigners to buy shares listed on the KSA bourse by entering into swap agreements with authorized persons. Saudi investors, who are licensed intermediaries, were allowed to enter into swap agreements with non-resident institutional and individual investors. Saudi investors can retain legal ownership of the shares while transferring economic benefits to foreign investors.

KSA Markets Continue to be Least Liberalized in the GCC

Despite the calibrated opening of the equity market in August 2008, Saudi bourses remain amongst the least liberalized in the GCC region (see table below). The UAE and Qatari stock markets encourage greater foreign investor participation compared to Saudi Arabia. The Egyptian Capital Market Authority was amongst the first in the Middle East to liberalize the stock market and allow GDRs in London. Capital markets in Saudi Arabia were also liberalized later than in other emerging countries. Efforts to liberalize stock markets in emerging markets over the past two decades laid the foundation for the growth of equity classes. Most emerging economies have already liberalized their stock markets, albeit with varying degrees of regulation. However, opening up of the capital market to foreign investors could prove to be a landmark development in shaping the overall development of capital markets in KSA.
Table 6: Establishment of independent regulator in KSA trails emerging and GCC market peers

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulation governing foreign participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>Foreigners are allowed to buy shares listed on the KSA bourse by entering into swap agreements with authorized persons. And ETFs.</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Foreigners residing in Bahrain for a year or more are entitled to purchase, own and trade up to 49% of the domestic company’s equity.</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Foreigners are permitted to buy, own and trade Kuwaiti companies’ stock. Non-Kuwaitis also have the right to vote and nominate.</td>
</tr>
<tr>
<td>UAE</td>
<td>Foreigners are permitted to buy, own and trade in UAE companies’ stock.</td>
</tr>
<tr>
<td>Qatar</td>
<td>Foreigners are permitted to buy, own and trade Qatari companies’ stock.</td>
</tr>
<tr>
<td>Oman</td>
<td>Foreigners are permitted to own up to 70% of listed companies on Omani Stock Exchange.</td>
</tr>
<tr>
<td>Egypt</td>
<td>Foreigners are permitted to buy, own and trade in Egyptian companies’ stock.</td>
</tr>
</tbody>
</table>

Source: AlJazira Capital
Conclusion

The Financial Role of the Saudi Capital Market is expected to grow in the Future

As Saudi Arabia recovers from the recent economic slump, it is expected to require additional financing. The Kingdom’s economy expanded 0.15% in 2009 even as the global economy is estimated to have contracted 1.4%. According to the IMF, at 4.0% in 2010, the Saudi economy will be the second-fastest growing economy in the GCC region after Qatar. We expect private sector companies in KSA to resume their expansion initiatives, which were stalled during the downturn. The Kingdom’s government would also require access to additional finance given its commitment to maintain the expansionary budget. KSA expects to spend SAR540bn in 2010 due to the substantial focus on infrastructure projects to rev up the economy. The budget deficit is set to reach SAR70bn in 2010 from SAR45bn in 2009. The government has earmarked USD400bn for infrastructure projects over the next five years. Currently, projects worth more than USD700bn are in different stages of implementation across sectors. Saudi Arabia has also been actively encouraging private sector participation in several government projects. These factors indicate the huge financing requirements that the KSA economy will likely come across in the coming years.

KSA’s long-term fundamentals are also intact primarily due to the Kingdom’s economic diversification plans. In the last few years, there has been a dramatic change throughout the GCC with regard to development plans and investment strategies. The primary objective of the diversification is to reduce dependence on hydrocarbons by increasing domestic investments in the financial, construction, real estate, tourism and social infrastructure (healthcare, education, training and innovation) sectors. The GCC economies’ efforts to reduce dependence on the hydrocarbon sector by diversifying into other sectors, especially infrastructure development, has resulted in phenomenal growth in the real estate and construction sectors in the past few years.

Ambitious projects such as economic cities are likely to unleash a second wave of industrialization in core sectors, generating substantial employment opportunities in the long term. The Kingdom’s economy performed exceptionally well during the last five years due to the sustained boom in oil prices and the government’s diversification initiatives. The non-oil sector has grown impressively during the last several years due to strong government support and regulatory and institutional reforms. A period of rapid economic growth and overall macroeconomic stability brought foreign money into the economy besides creating a conducive environment for the development. The comprehensive development of capital markets will not only aid the KSA economy in meeting its huge financing requirements to fund economic growth but also help it emerge as a regional financial hub in the coming years.
COMPANY PROFILE

AlJazira Capital, the investment arm of Bank AlJazira, is a Shariaa Compliant Saudi Closed Joint Stock company and operating under the regulatory supervision of the Capital Market Authority. AlJazira Capital is licensed to conduct securities business in all securities business as authorized by CMA, including dealing, managing, arranging, advisory, and custody. AlJazira Capital is the continuation of a long success story in the Saudi Tadawul market, having occupied the market leadership position for several years. With an objective to maintain its market leadership position, AlJazira Capital is expanding its brokerage capabilities to offer further value-added services, brokerage across MENA and International markets, as well as offering a full suite of securities business.

For further queries about our special services, contact us at the toll free number 800 116 9999.
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