

THE REPORT

Kuwait 2012

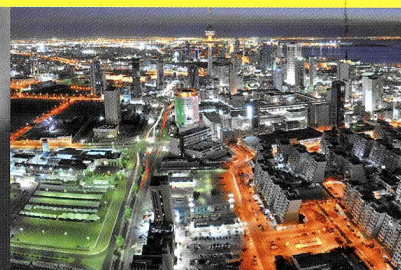
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The KSE is the third-largest exchange in the GCC region

In transition

Developing a more transparent and dynamic bourse

With an evolving regulatory environment and a shift in the way investment companies operate, the Kuwait Stock Exchange (KSE) is at something of a crossroads. One of the oldest exchanges in the region and the third-largest in the GCC, the KSE has been affected by both domestic and international events in recent years.

OPERATING ENVIRONMENT: The global credit crisis that sent exchanges across the world into precipitous declines has transmuted into more generalised fears over US and European debt; regional bond defaults have revealed previously unsuspected economic fault lines and shaken investor confidence, while locally, a financial sector which had grown accustomed to easy profits has struggled to adjust to leaner economic times. The net result of these pressures has been a sharp drop-off in liquidity on what was until recently one of the most vibrant bourses in the Gulf – a phenomenon repeated in exchanges the world over.

However, rather than wait for regional and global macroeconomic conditions to right themselves, Kuwait has responded to the challenges faced by the KSE with one of the most comprehensive structural reforms in its history. In line with the Capital Markets Law (CML) passed in February 2010, a new Capital Markets Authority (CMA) has been established and the plan for the privatisation of the bourse has been outlined – both moves which, although still in early stages, have the potential to facilitate a new era of expansion.

HISTORY: Although a number of shareholding companies existed in Kuwait prior to the establishment of the KSE, the legal formalisation of the bourse in 1962 marks the true beginning of the country's capital market. As one of the region's most established exchanges it has ridden out more challenging conditions than those prevailing today, and has a track record of adapting itself to new conditions, which underlies the optimism surrounding its long-term future. In the 1970s an overly inflated index, driven by the oil boom, resulted in the sharp correction of 1977, which saw the government bail out investors and introduce tighter regulations.

Seeking to sidestep a more closely supervised bourse, some investors eschewed the KSE in favour of an informal, unregulated market, Souk Al Manakh. However, a combination of inflated prices and an uncontrolled settlement system (often using cheques post-dated by as much as six months) led to another chain reaction of defaults in 1982, leaving the National Bank of Kuwait as the only solvent lender in the country. After a reorganisation of the exchange and its establishment as an independent entity in 1983, the 1990-91 Gulf War interrupted the complicated process of unwinding defaulted positions, and the government was compelled once again to provide a bailout of sorts.

The destruction of much of the documentation pertaining to the crisis left debt forgiveness as the only option. The following decades brought more stringent regulation and, in turn, an expansion in listed firms and trading volume, culminating in a period of sustained growth which lasted until the onset of the global economic crisis of 2008.

All bourses in the region have been presented with new challenges as a result of the ensuing economic turbulence and most are confronting them through a process of regulatory reform.

One legacy of Kuwait's history of challenging market events is that its government is determined to ensure that its reform agenda is as comprehensive as possible and will likely bring a best-practice regulatory structure to end the bailout culture that many argue has only encouraged malpractice in the past.

MARKET STRUCTURE: Today's bourse, with a total market capitalisation of around \$100bn as of January 2012, is the third-largest in the GCC, behind Saudi Arabia's Tadawul and Qatar Exchange. At the outset of 2012 some 215 companies were listed on the KSE, organised into eight sections: banking, investment, insurance, real estate, industrial, services, food and foreign companies. The KSE operates a parallel market comprised of 14 listed firms, the lower capital requirements of which allow smaller companies to access liquidity

The 215 companies listed on the bourse are currently organised in eight categories. In addition, the market operates a parallel market of 14 listed firms.

via equity offerings. For now, the KSE remains a single product (equity) exchange, but significant changes to both its regulatory and technical framework are laying the groundwork for the introduction of more complex instruments that have proved popular in other markets, such as exchange-traded funds (ETFs) and derivatives. The technical enhancements rolled out in 2011 came primarily as a result of an agreement signed with Nasdaq OMX, the owner of New York’s Nasdaq Exchange and several bourses in Europe, in late 2009. Under the three-year agreement Nasdaq OMX has committed to providing strategic advisory services to the KSE as it develops the national capital market, but the most significant structural change arising from the partnership comes in the form of the US-based company’s propriety trading platform, use of which will facilitate more efficient equity trading, the creation of a secondary bond market and the introduction of derivatives.

INDICES: As part of its structural reforms, the KSE is also introducing a new family of indices and overhauling the market sector classification system. The first new index to be launched, in conjunction with the new trading platform, is the Kuwait 15 Index, composed of the top 15 KSE-listed companies ranked by liquidity and market capitalisation, which is intended to become the bellwether of the Kuwait economy. The companies listed on the first Kuwait 15 Index will be reviewed semi-annually. The National Bank of Kuwait tops the list, which also includes Zain and the Kuwait Finance House. The new sector classifications will see the replacement of the old eight-sector system with 15 classifications intended to align the bourse with international standards: oil and gas, basic materials, industrials, consumer goods, health care, consumer services, telecommunications, utilities, banks, insurance, real estate, financial services, investment instruments, technology and parallel (which covers the parallel market).

PERFORMANCE: These structural changes are taking place at a time of historically low activity, which the KSE and exchanges across the region have endured since the economic crisis of 2008. In that year it followed a global trend of decline, experiencing rapid sell-offs across all eight sectors to lose around 42% of its value of approximately KD24bn (\$86.5bn) by December 31. Trading volumes in 2009 remained muted, showing a



Implementation of a new propriety trading platform is expected to support a secondary bond market

brief uptick in the fourth quarter to post a daily average of 430.5m shares traded, worth KD88.38m (\$318.6m). An anticipated recovery by the end of the year failed to materialise and the KSE Weighted Index slipped 5.15% to 385.75 (from 406.70) as the Dubai World debt crisis reduced investor confidence across the Gulf. However, during the first months of 2010 a number of developments combined to provide the market with a much-needed fillip: parliamentary approval of the government’s five-year KD30bn (\$108.2bn) economic development plan, a discount rate cut by the Central Bank of Kuwait, the approval of a new CML and news of progress regarding Zain’s sale of its African assets saw market capitalisation rise by 14.2% in the first quarter, to KD34.47bn (\$124.4bn), and the KSE Weighted Index post a 14.3% gain.

Investors stayed on the sidelines in the second quarter of 2010 amidst renewed concerns about Europe’s debt crisis. In the absence of new growth drivers closer to home, the KSE Weighted Index slid 9.9%. It was to surge again by 14.5% in the third quarter on the back of better-than-expected first-half results from the banking sector and the government’s decision to finance its massive development plan through local lenders before making an 11% gain in the fourth quarter. December 2010 saw market capitalisation grow nearly 4.7% year-on-year to KD36.2bn (\$130.5bn), while the KSE Weighted Index recorded an annual gain of 25.5%.

LIQUIDITY: However, this apparent recovery was undermined by declining liquidity over the year, with average daily trades falling from KD88m (\$317.2m) in 2009 to just KD51m (\$183.9m), the result of muted investor sentiment, tightening lending criteria by banks, more stringent liquidity requirements placed on investors and asset managers, and the suspension from trading of a number of struggling investment companies.

This trend continued into the first half of 2011. Average traded value, which stood at KD30.2m (\$108.9m) at the beginning of the year, had decreased to just KD15m (\$54m) by July, while the KSE Weighted Index

To align the bourse with international standards, new sector classifications will replace the old eight-sector system with a set of 15 categories.

MENA domiciled funds AUM (\$ m)				
	Q4-2010	Q1-2011	Q2-2011	Q3-2011
Bahrain	5660	5420	5182	4983
Egypt	9498	8134	8471	7582
Jordan	14	12	10	9
Kuwait	9460	8893	8840	8537
Lebanon	339	346	413	418
Morocco	13,081	13,185	15,318	13,617
Oman	198	186	161	181
Qatar	181	176	175	164
KSA	25,220	23,698	23,698	22,789
Tunisia	3554	3625	3707	3658
UAE	820	802	895	713

SOURCE: Zawya



In January 2012 the CMA announced moves to privatise the stock exchange

dropped by 14.2% over the same period. Fears over US and European sovereign debt played a part in the decline, as did the regional unrest sparked by events in North Africa. However, some of the decrease in trade volume can be ascribed to investors awaiting the results of the implementation of the new sector law and the formation of the regulator, moves that, although depressing liquidity levels in the short term, have the potential to radically alter the workings of the KSE and bring about a new phase of expansion.

REGULATORY REFORM: In February 2010 the parliament passed the CML, thereby putting into effect a process that promises comprehensive reform for the KSE and the institutions that interact with it. The law established a new institution, the CMA, which will act as a unified regulator over the market and securities business, replacing a fragmented system in which the Ministry of Commerce and Industry, the Central Bank of Kuwait and the exchange itself provided imperfect regulatory coverage. The legislation also set in motion the plan to privatise the stock exchange.

The regulator, which began operations in April 2011, has been granted the power to issue the bylaws and instructions to realise the vision of the CML, encompassing the regulation and licensing requirements of the KSE and any future exchanges (including asset management firms, mutual funds and financial brokerages), the regulation of initial public offerings (IPOs) of Kuwaiti and non-Kuwaiti securities, the promotion of mutual funds and other collective investment schemes, and the supervision of mergers and acquisition activity of listed companies (particularly in regard to protecting the rights of minority shareholders).

The executive of the CMA, a five-member Authorised Council, will remain under the supervision of the Ministry of Commerce and Industry, working closely with the central bank and the KSE to address long-standing concerns regarding volatility, market manipulation, transparency, corporate governance and the interests of the local investor class – many of whom are minor-

ity shareholders who were adversely affected during the recent economic turbulence. The potential benefits of the new legislation are manifold, but much will depend on the executive bylaws formulated by the CMA as it sets about its programme of reform. These were finally issued in September 2011.

“The enabling regulations issued following a protracted period of false starts and disagreement among the lead regulators even now provide for ongoing adjustment, with much discretion granted to the CMA in their implementation. And therefore how the new regime will ultimately work is uncertain, which remains a concern,” Anthony Coleby, partner at Al Markaz Law Firm, told OBG. “Added to this is the question of the stock market court created by the law, which has emerged with considerable powers that effectively establish it as Star Chamber of the KSE.”

The full implementation of the CML will thus clearly take some time and, while the potential benefits it brings to the sector are clear, its effect in the short term has been to slow activity on the exchange, as investors await the results of the process.

The latest move in a line of new regulations intended to boost transparency in Kuwait’s exchange is the January 2012 announcement that the CMA had hired HSBC to help privatise the stock exchange. The move was widely viewed as a step forward, toward a model which is more in line with the West.

INVESTOR PROFILE: The overriding intent behind the formation of the CML and the establishment of the CMA is to boost activity on the exchange and reverse the decline experienced in recent years. One way in which this might be accomplished is by changing the investor profile of the KSE from “local and individual” and to “foreign and institutional”. Foreign investors have been permitted to buy equities on the bourse since 2000, although foreign individuals and groups are limited to maximum ownership of 49% of a KSE-listed company.

However, analysis of trading volumes reveals that local retail investors account for the majority of activity – an investor profile which, when liquidity flows were at their height prior to the global economic crisis, was responsible for a great deal of volatility.

In July 2011 Kuwaiti individuals accounted for 37.7% of buying activity, while local companies represented 24.9%, investment funds 10.6% and client accounts 17.9%. Individuals residing elsewhere in the GCC accounted for only a fraction of purchases in July 2011, 1.6%, while buying activity by companies in the region represented 1.3% of the total, GCC investment funds 0.5% and GCC client accounts a negligible 0.001%. Foreign individual buyers from outside the GCC represented 3% of activity, while foreign companies accounted for 2.1% of activity and investment funds 0.3%.

The process of reform aims to bring about improvements in transparency and governance, which are highly valued by foreign and institutional investors, significantly enhancing the attractiveness of the market.

INVESTMENT COMPANIES: The need for effective oversight of activities relating to the KSE is clearly illustrated by the ongoing challenges faced by investment

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companies in the wake of the global economic crisis. A number of companies had entered the market in the years prior to 2008, and enjoyed sustained profitability by employing a straightforward business model: borrowing from local (and, increasingly, foreign) banks to invest in a booming stock market either in the form of proprietary trading or by allowing clients to run margins for the same purpose.

The precipitous decline of the market in late 2008 put a significant number of investment companies out of business. The exact figure is hard to discern as many have refrained from disclosing financial results since 2009 – several have not disclosed them due to ongoing disputes with the central bank regarding their financial statements and the accounting principles used in their preparation – and have found themselves delisted from the exchange as a result.

According to Faisal Al Mutawa, the chairman and managing director of local investment firm, Bayan Investment, the melting asset prices have caused something of a snowball effect, as investment firms have been forced to sell assets at these low prices to meet shorter-term debt obligations, further reducing an already weak portfolio. “The key to survival is managing how to service your liabilities in the most effective way possible,” Al Mutawa told OBG.

STABILITY LAW: The banks’ exposure to the segment has placed a strain on the entire financial system, but, rather than resort to the bailout policy which many believe has contributed to reckless behaviour in the past, the government has tackled the problem with the Financial Stability Law (FSL), initially enacted by Amiri decree and then ratified in May 2009. The law addresses the financial sector in the round, but with regard to investment companies the assistance it offers is restricted to those with liquidity, and not solvency, problems. Those that meet the solvency requirements of the FSL are eligible to receive government-backed guarantees for up to 50% of new finance from local banks to settle obligations to local parties (but not local banks) and reschedule debt to local and foreign banks.

A further provision grants the Kuwait Investment Authority the ability to inject capital into investment companies that are accepted to the programme and establishes the government’s right to subscribe for equity and even take over a company if the capital need is large enough. However, the demanding eligibility requirements of the FSL and the freedom it grants the central bank to make alterations to firms’ operations (such as mandating cost reductions, effecting changes in organisational structure and even forcing mergers) has resulted in just two companies applying, successfully, for assistance under its provisions.

Fawaz Al Issa, the vice-chairman and CEO of the sharia-compliant private equity house, Turkapital, told OBG that the crisis has changed the standards for evaluation and analysis. “It used to be a lot more based on financial models. Now we look at many qualitative factors as well; it is much more subjective,” he said.

INVESTMENT FUNDS: Despite the challenging economic environment, of the 115 investment companies reg-



Reform and the government's spending programme are expected to benefit the expansion of the exchange

istered with the Central Bank of Kuwait, many have succeeded in building sustainable business lines, and, alongside banks with investment arms, those with a wider frame of operations have been able to find profit in the KSE. “Although many companies are looking outside of the country at the moment, there are still a lot of opportunities in Kuwait, specifically in restructuring, financial advisory and debt capital markets,” Issam Z Al Tawari, the chairman and managing director of Rasameel Structured Finance Company, a local Islamic investment company, told OBG.

There are 60 investment funds domiciled in Kuwait, 37 of which are equity based, with about \$5.7bn of assets under management (AUM). The National Investment Company is the country’s largest fund manager, with total AUM of \$1.1bn at the start of 2011, and runs the largest equity fund based in Kuwait – Al Wataniya Investment Fund, worth \$542m. A third of funds on the KSE are sharia-compliant, between them claiming around 22.6% of total AUM, and, like their conventional counterparts, equities represent the dominant asset class.

OUTLOOK: In the short term, uncertainty surrounding the implementation of the new regulatory framework and the challenges faced by heavily leveraged investment companies are likely to continue placing some downward pressure on trading volumes. However, while the KSE remains a single-product market, the planned introduction of new instruments made possible by an ongoing process of regulatory and structural reform is expected to bring new depth to the exchange in the medium term. Kuwait has traditionally been a regional leader in sovereign bond issuance, and, although corporate issues have slowed, new regulations tackling transparency and governance and the creation of a secondary market offer a route to renewed growth (see analysis). As well as structural reform, improving macro-economic conditions and the beneficial effects of the government’s KD30bn (\$108.2bn) spending programme combine to provide a basis for the long-term expansion of one of the Middle East’s largest exchanges.

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