The Saudi Stock Market: Development, Structure And Future Prospects

by Riyad M. Al-Dughaither

The outlook for the Saudi stock market in the short term may be described as "neutral," but in the medium and long term, the Saudi market is a market to watch. The market's potential is based on a number of factors, including Saudi competitive advantages, the Saudi private sector's significant asset base, the mega-privatizations slated for the coming years, and development of the stock market thus far.

Beginnings

Saudi joint stock companies had their beginnings in the mid-1930s, when the first such company, the Arab Automobile Company, was established.[1] By 1975, 14 joint stock companies had been established in the Kingdom,[2] with a combined paid-up capital of SR 1.6 billion[3] (about $420 million). These companies were generally closely held, with shares rarely exchanging hands. They included Riyad Bank, which at the time was the only publicly held bank.

With the onset of rapid economic expansion in the 1970s, a number of large corporations were established, and they placed major share offerings to the Saudi public. Among these companies was the Saudi Basic Industries Corporation (SABIC), which is responsible for the bulk of Saudi Arabia's modern day petrochemicals sector. SABIC is the most highly capitalized company traded on the stock market today.

A number of publicly held joint venture banks were also established. These banks are jointly owned by the Saudi public and major foreign banks that had a presence in Saudi Arabia in the mid-1970s to early 1980s. They include Citibank, British Bank of the Middle East, ABN-Amro, and Banque Indosuez. Combined, they represented—and continue to represent—a substantial portion of the stock market's capitalization.

These large public share offerings, along with the higher liquidity created by the rapid growth of the Saudi economy, activated the secondary market in company shares. Until the mid-1980s, this market was an informal, over-the-counter market, with trades executed mainly at small brokerages houses that were loosely regulated.

Regulatory and Systems Developments

In April 1983, to improve market regulation and transparency, the Ministry of Finance restricted share trading

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Riyad M. Al-Dughaither is Assistant General Manager, International Banking Division, in the head office of Riyad Bank in Riyadh. This article is an updated version of a paper he presented at the ABANA conference on Saudi Arabia held in New York last year.

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intermediation or brokering to Saudi commercial banks.[4] And in December 1984, the Saudi Arabian Monetary Agency (SAMA), the Kingdom's central bank, established a share trading regulatory system[5] that was similar to the systems in Germany and Switzerland at the time.[6]

In 1985, Saudi Arabia's official share index was started, as the Ministry of Finance's National Center for Financial and Economic Information began publishing the NCFEI index. This is a capital weighted index of company share prices on the stock market.[7]

A committee charged with supervising the secondary market in shares was established in the early 1980s. Called the Ministerial Share Control Committee, it consists of representatives of three government organizations: the Ministry of Finance, the Ministry of Commerce and SAMA. And the Share Control Department was established under the auspices of SAMA to supervise Saudi share trading.[8]

In addition to functioning as a regulator, SAMA played a vital role in developing the Saudi stock market system to a level that is comparable to the most recently developed systems in the world. To accomplish this, SAMA decided to use information technology specifically developed for the trading environment in Saudi Arabia. The Electronic Securities Information System (ESIS) was introduced in 1991.[9]

ESIS basically created a *floorless*, computer-based stock market spanning the Kingdom. This system allowed buy and sell orders entered at one bank's share trading terminal to be matched instantaneously with corresponding sell and buy orders entered into the system by any other bank or, indeed, the same bank.

Further developments in this system include the introduction of ESISLINE in 1992 and ESISNET in 1993. With these developments, it is now possible for a prospective buyer or seller to enter any connected Saudi bank branch, observe the market for the company in question, place an order that can be executed in seconds (if it is within the market price range), and have it settled within 24 hours, complete with the exchange of transaction proceeds and documentary evidence of new title. This certification can be printed out at the same branch where the order was placed.

Performance

How have these regulatory and systems developments affected the market? First, they have obviously increased efficiency and transparency, as the market for a company's stock is instantaneously visible and its buy/sell spreads substantially narrowed. Second, the value of shares traded has increased 31-fold, from approximately $200 million in 1985 to around $6.2 billion in 1995. The number of trades and the number of shares traded have increased close to 40-fold.[10]

Market capitalization, which was around $20 billion in 1987, reached $55 billion by the end of 1992. Since then, capitalization went from $51 billion at the end of 1993, to

$38 billion by the end of 1994, and $41 billion by the end of 1995.[11] The number of publicly traded companies has increased from 46 in 1987 to 70 currently.[12]

In terms of capitalization, the market is dominated by banks and industrial corporations, including the cement industry. Together, they comprise more than three fourths of the market's capitalization.[13] The other sectors are utilities, services, and agriculture. As a percentage of GDP, the market's capitalization is approximately 33 percent,[14] which compares favorably with a number of markets in the region.

Over the last decade, the volatility of the Saudi stock index[15] compares reasonably well with that of most emerging and some established markets, including Japan, New Zealand, Hong Kong, Singapore, Korea, and Taiwan.[16] Over the period from 1991 to 1995, in spite of the impact of the Gulf crisis, the best annual year-end performance of the index was an 81-percent increase, while the worst annual performance showed a decline of 29 percent.[17] This variance compares favorably with, for example, that of Hong Kong's Hang Seng index, where the best year-end annual performance was a 115-percent increase, and the worst was a decline of 34 percent,[18] over the same five-year period.

Accounting practices in the Kingdom have improved in recent years, with Saudi banks now implementing more elaborate accounting standards and disclosure requirements promulgated by SAMA. SAMA has also established a Banking Institute that trains and certifies prospective Saudi share dealers before they are qualified to trade on the securities system at commercial banks.

Market valuation is generally rational, with market ratios, excluding the subsidized utilities sector, recently standing at an average P/E of around 9x, average price to book at approximately 1.5, and average dividend yield at 6.3 percent.[19] These ratios should be viewed in the context of the level of interest rates, which generally track U.S. rates within a relatively small range, given the Saudi riyal's high correlation with the U.S. dollar. Short-term rates on the riyal are now around five percent, and medium-term rates around 6.5 percent. Average year-end P/E ratios over the last five years have ranged from a low of 12x in 1995 to 21x in the 1991-1993 period. Average year-end dividend yields have ranged between 2.7 percent and 4.9 percent. Average year-end price-to-book ratios ranged between 1.65 and 2.45 over the same five-year period.[20] As noted, these valuation ratios exclude the subsidized utilities sector.

Within this generally rational context, average returns on the Saudi stock market over the last five years were around 12 percent. Although the market consolidated significantly over the last three years (down five percent in 1993 and 28 percent in 1994, but up 7 percent in 1995), its average returns compare reasonably well with those of major markets over the same period, such as in the U.S., Germany, and Australia.[21]

Participation and Benefits

Participation in the Saudi stock market is restricted in that only Saudi nationals and Gulf nationals (on a selective basis) are allowed to trade in Saudi shares. This does not mean, however, that noncitizens have not benefited from the Saudi market.

For example, foreign banks that entered into joint ventures with the Saudi public through joint stock companies have enjoyed substantial financial rewards. In the case of one joint venture bank, the value of the foreign partner's shares increased in value approximately 36-fold, in dollar terms, over the last 14 years (through 1995); this does not include dividends repatriated, which exceeded the value of its investment many times over during the same period. Fourteen years after the establishment of another joint venture bank, the value of the foreign partner's investment had grown approximately 17-fold in dollar terms; its cumulative dividends repatriated over the 14-year period also were many times its original investment.

Successful joint ventures are not limited to the banking sector. A number of foreign industrial companies have joint ventured with the Saudi public through joint stock-holding companies, such as SABIC, and have realized substantial returns on their investments, especially in the petrochemicals sector. Examples include Sadaf (SABIC/Shell joint venture); Sharq (SABIC/Mitsubishi joint venture); Samad (SABIC/Taiwan Fertilizer joint venture); and Ibn Zahr (SABIC/Ecotel/Neste Oy/Apicorp joint venture).

These examples provide anecdotal evidence that Saudi capital raised through joint stock companies, paired with well-suited advanced technology and skills, can produce mutually beneficial results.

These are examples of benefits attained by foreign companies through indirect tapping of the Saudi stock market, but there has long been a debate in the Kingdom regarding a controlled broadening of direct foreign participation in the Saudi stock market. Given the regional and international trends in this respect, it is my belief that a gradual and prudently controlled broadening of the scope of participation in the Saudi market may take place when the timing is appropriate.

Outlook

As noted at the beginning of this article, the outlook for the Saudi stock market in the short term is neutral, given the uncertainty surrounding relevant fundamentals, including fluctuations in U.S. interest rates (and hence, Saudi rates). In the medium and long term, however, it is not a market to be ignored.

Saudi Arabia's economy has developed rapidly, fueled by a number of critical advantages. These begin with a modern and extensive infrastructure, and include: cheap energy, a substantial mineral resource base, low taxation, moderate to low labor costs, attractive incentives for industrial investment, a stable and freely convertible currency, and quickly developing capital markets.

On the primary capital market front, there have been a number of new share issues over the last three to four years (Saudi Investment Bank is the most recent). The great bulk of these have been substantially oversubscribed. An example is the Riyad Bank share issue in early 1992. The bank offered eight million shares for approximately $1 billion, the largest share issue in Saudi history.[22] It received close to $3.4 billion in subscriptions.

While liquidity in the market is not as great as it was four years ago, the Saudi private sector can still draw on a significant asset base. There are no figures on Saudi private sector foreign assets, but estimates range from $140 billion to \$300 billion, including those attributable to, or managed by, Saudi banks.[23] This private sector resource base will be attracted into productive investment in the Kingdom by domestic projects that build on Saudi Arabia's comparative advantages teamed with advanced technology, skills, and associated risk capital.

Finally, a number of mega-privatizations scheduled for the coming years should further stimulate Saudi capital markets. These include the much-debated privatization of the national airline Saudia, the Saudi Telecom Corporation, and possibly government shares in major corporations such as SABIC. The potential here is huge. The Saudi government, however, has made clear that it intends to privatize selectively and gradually, and only after thorough study and consideration.

Footnotes

[1]S. A. Banafe, *Saudi Arabian Financial Markets*, 1993, p. 173; reproduced by permission of SAMA (Saudi Arabia Ayyoubi Printers).

[2]R. S. Al-Haddad, *Testing the Factors Affecting Returns on Saudi Joint Stock Company Shares*, 1991, p. 49 (Riyad Bank).

[3]*Id.*

[4]S. A. Banafe, *supra* note 1, p. 177.

[5]*Id.*

[6]*Id.*

[7]*Id.*, p. 175.

[8]*Id.*, p. 177.

[9]*Id.*, p. 179.

[10]Research Unit, Equity Investment Department, Riyad Bank, Riyadh, Saudi Arabia (February 26, 1995).

[11]*Id.*

[12]Research Unit, Equity Investment Department, Riyad Bank, Riyadh, Saudi Arabia (September 1996).

[13]Research Unit, *supra*, note 10 (February 26, 1995).

[14]Ministry of Finance, OAPEC, Annual Report, 1993.

[15]Research Unit, *supra* note 10 (March 11, 1995).

[16]Fleming Research, Robert Fleming (U.K. Merchant Bank), London, England (1994).

[17]Research Unit, *supra* note 10 (March 11, 1995).

[18]Fleming Research, *supra* note 16.

[19]Research Unit, *supra* note 10 (February 28, 1995).

[20]*Id.*

[21]*Id.* (February 27, 1995).

[22]*Id.* (March 12, 1995).

[23]Various private bankers' estimates.