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STRATEGY NOTE

Kuwait: Ready for a FTSE Upgrade?

NBK CAPITAL
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HIGHLIGHTS

- Kuwait seems to be **on track to be classified as a Secondary Emerging Market by FTSE** Russell by the end of September 2017. The timeline and the mechanism of the actual inclusion, however, is still unclear.

- Expectations at this point is that after the **formal announcement in September 2017**, and due to liquidity constraints, the inclusion will follow a phased approach with 50% of the weight included in September 2018 and 50% in March 2019.

- FTSE follows a well-documented, standard methodology for country classification. After adjusting the settlement and clearing cycle back in May 2017, **Kuwait seems to have satisfied all the technical requirements to be classified as a Secondary Emerging Market**. Such changes, however, still need to be reviewed and approved by FTSE.

- Even though the actual inclusion would most likely happen a full year after a favorable outcome of the September 2017 meeting, the **announcement in itself would constitute a positive catalyst for the local market.**

- Following previous instances of country upgrades, we would expect a run-up in the market around the announcement period and in the months leading up to the effective date(s) of the inclusion.

Introduction

Kuwait has been on the FTSE's Watch List for possible inclusion in the FTSE Global Equity Index Series as a Secondary Emerging Market since 2008. It was only in the past couple of years, however, that changes have started to be implemented in the market, mainly along the lines of enhancements to the settlement cycle, to bring it closer to compliance with international standards and with the requirements of the Quality of Markets Matrix of FTSE.

The latest FTSE Country Classification interim update published in March 2017 states in the section regarding Kuwait that "FTSE Russell awaits full implementation of the planned enhancements to the settlement cycle and the delivery versus payment process scheduled for March 2017". It also states that Kuwait will be retained on the Watch List and will be reviewed for possible inclusion at the Annual Review in September 2017.

Many market participants and analysts are expecting that the inclusion of Kuwait in the FTSE EM index will be announced in the September 2017 meeting with the implementation happening in September 2018. It remains unclear, however, if the inclusion happens, whether the implementation will be in one go or be phased like in the case of Qatar. Due to liquidity concerns, Qatar's upgrade happened in two tranches; after an announcement in September 2015, 50% was included in September 2016 and 50% in March 2017.

In this note, we will review and summarize the process and the requirements of the FTSE Russell country classification and inclusion process. We will also examine the recent performance and activity of the Kuwaiti market, and then try to assess the impact such an inclusion might have.

FTSE Russell Country Classification Methodology

FTSE global indices include countries that are classified into four broad groups: Developed, Advanced Emerging, Secondary Emerging and Frontier. A minimum set of criteria has to be met for a country to qualify for each classification and these criteria increase as we move up the scale from Frontier to Secondary Emerging, to Advanced Emerging and Developed.

According to the FTSE Country Classification Process paper published in March 2017, the formal process that is put in place includes the following elements:

- A **Quality of Markets Matrix** against which markets could be objectively judged and compared.
- A questionnaire with which to engage stock exchanges and regulatory authorities, the responses to which would help form the basis of the initial Quality of Markets assessment and subsequent upgrades.
- A new FTSE Russell Country Classification Advisory Committee reporting to the FTSE Russell Policy Advisory Board that would undertake objective assessments of markets against the Quality of Markets criteria.
- A **Watch List** consisting of those countries that are judged to meet, or to be close to meeting, the Quality of Markets criteria for promotion or demotion that would act as a staging post for subsequent country classification changes.

- A policy of engagement with markets that were placed on the Watch List to help them understand what steps would need to be taken to improve their current assessments to make them eligible for promotion (or to prevent their demotion).
- An annual schedule for determining country classification and Watch List changes culminating in country classification and Watch List changes being announced in September.
- A defined communication and implementation timetable to allow portfolio managers to make the necessary preparations for changes to classifications.

Of the above elements, the core is the Quality of Markets Matrix. The matrix evaluates the quality of the markets being considered according to a detailed set of criteria that are considered essential for each classification, in addition to Credit Worthiness and Gross National Product per Capita. These are grouped into four main categories:

- Market & Regulatory Environment
- Custody and Settlement
- Dealing Landscape
- Derivatives (only applicable for Developed Market classification)

Each of the above categories is broken down into detailed criteria that are considered essential for each classification. A full table detailing the Matrix is presented in Appendix A of this note.

The classification and inclusion process is based on the principle that investors should have ample time to adjust and rebalance their portfolios and have enough comfort that the criteria assessed through the Matrix are being implemented in practice. Therefore, a country must stay on the Watch List for at least one full year before it is considered ready for reclassification, even if it meets all requirements from the outset.

Once a country meets the required criteria it will be eligible for inclusion in the FTSE Global Equity Index Series. However, the country's stock exchange must have at least 3 companies that pass the securities eligibility criteria before that country's index is constructed and added to the FTSE Global Equity Index Series.

Among other things, the three most important security eligibility criteria are Free Float, Foreign Ownership Limits, and Liquidity.

Free Float: The Free float calculation excludes shares that are not available to the public and that are regarded as strategic long-term holdings. These could be shares owned by the government and government entities, shares held by employee share plans and by directors and senior executives of a company…etc. Companies with a Free Float of less than 5% will be automatically excluded.

Foreign Ownership Limits (FOL): Foreign ownership restrictions are also taken into account when calculating a company's investability weight. The more restrictive of the FOL and the free float is used in the calculation. A further complication is the Minimum Foreign Headroom Requirement. It is defined as "the percentage of shares available to foreign investors as a proportion of the company's FOL and is calculated as: FOL-foreign holdings/FOL)". A minimum of 20% headroom is required for a security to be included in the index.

Liquidity: Liquidity is central to the stock eligibility criteria. For the September review, liquidity is calculated from market data from the first day of July of the previous year to the last trading day of June of the current year. For each month, the daily volume for each security is calculated as a percentage of the total shares in issue adjusted for the free float and foreign ownership limit.

Generally, for a month to be marked as "Pass" the median of those daily values has to be at least 0.04% for 8 out of the 12 months under consideration for an existing constituent, and at least 0.05% for 10 out of the 12-month period.

The Case of Kuwait

Kuwait seems to have met all nine requirements for classification as a Secondary Emerging Market after the change in the settlement cycle to T+3. These upgrades were effected after the March review but the changes still need to be approved by FTSE.

Table 1. Kuwait's Assessment against Quality of Markets Matrix (as of March 2017)

Criteria	Advanced Emerging	Secondary Emerging	Kuwait
World Bank GNI Per Capita Rating, 2015			High
Credit Worthiness			Investment
Market and Regulatory Environment			
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	X	Pass
Fair and non-prejudicial treatment of minority shareholders	X		Pass
No or selective incidence of foreign ownership restrictions	X		Pass
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	X	Pass
Free and well-developed equity market	X		Restricted
Free and well-developed foreign exchange market	X		Restricted
No or simple registration process for foreign investors	X		Restricted
Custody and Settlement			
Settlement - Rare incidence of failed trades	X	X	Pass
Custody-Sufficient competition to ensure high quality custodian services	X	X	Pass
Clearing & settlement - T+2 / T+3	X	X	T+0, T+2
Settlement-Free delivery available			Not Met
Custody - Omnibus account facilities available to international investors	X		Not Met
Dealing Landscape			
Brokerage - Sufficient competition to ensure high quality broker services	X	X	Pass
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	X	Pass
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	X	Pass
Stock Lending is permitted			Not Met
Short sales permitted			Not Met
Off-exchange transactions permitted			Not Met
Efficient trading mechanism			Pass
Transparency - market depth information/visibility and timely trade reporting process	X	X	Pass
Derivatives			
Developed Derivatives Market			Restricted

Source: FTSE, NBKC

Table (1) above depicts an extract of the Quality of Markets Matrix with the relevant requirements for each classification (marked by x) against the scores of Kuwait. With the resolution of the Clearing and Settlement issues, which was still pending in March 2017, Kuwait now seems ready for the inclusion.

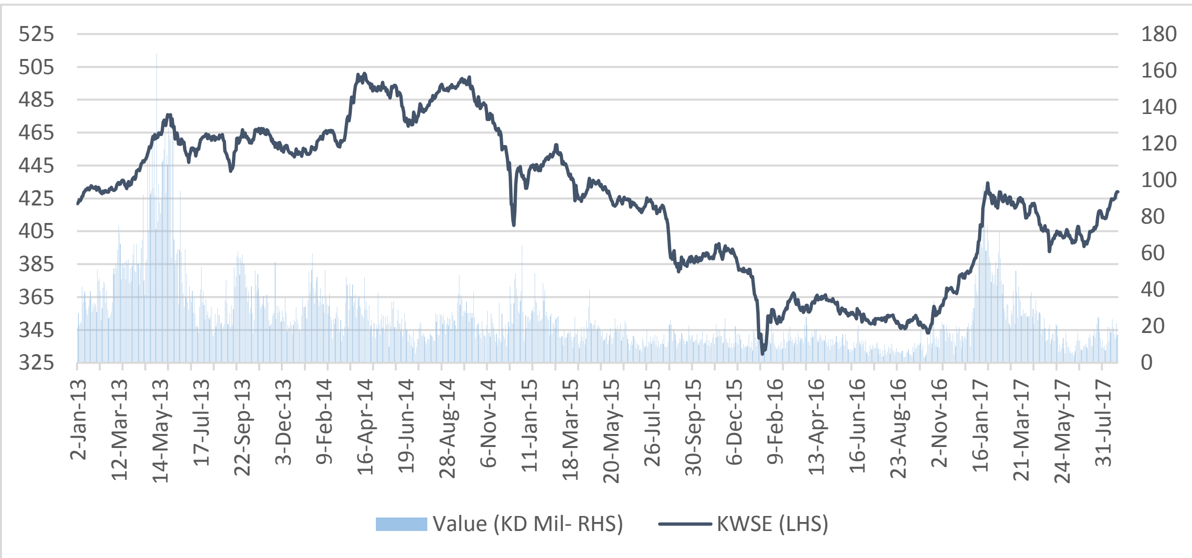
It does in fact have Pass rates for 11/15 of the requirements of the Advanced Emerging markets classification, and 3/15 partial fulfillment (Restricted) and only one that is scored Not Met.

Although analysts are not expecting any issues in Kuwait meeting the country classification criteria, liquidity levels remain a potential hindrance for stock inclusion.

Kuwait Market Performance Review

The Kuwaiti market has been out of favor with investors for a few years with underperformance and low levels of liquidity. It wasn't until late 2016 that the market started to attract interest and witnessed a significant pick up in performance while liquidity came back strongly.

Chart 1. Kuwait Weighted Index Historical Performance with Value Traded (KD Mil)

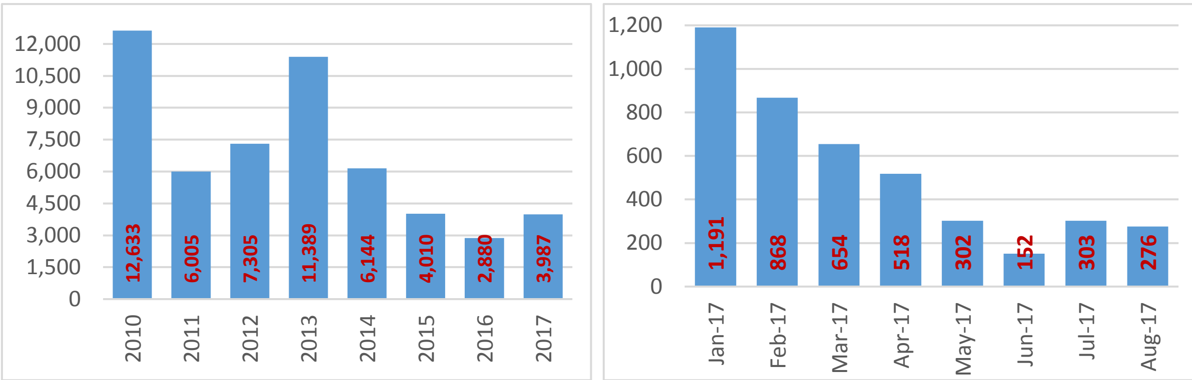


Source: Boursa Kuwait, NBKC

During the period from mid-October 2016 to end of January 2017, the weighted index added around 25% while liquidity increased from an average daily traded value of KD 10 million during the first 9 months of 2016 to a daily average of more than KD 26 million during the same period, with some trading days surpassing KD 80 million.

After a strong follow up during January to the performance of the last two months of 2016, liquidity started to fade and declined steadily until June before rebounding and stabilizing at around KD 300 million per month after the Holy month of Ramadan.

Chart 2. Value Traded on Boursa Kuwait (2010-2017, monthly for 2017, KD Mil)

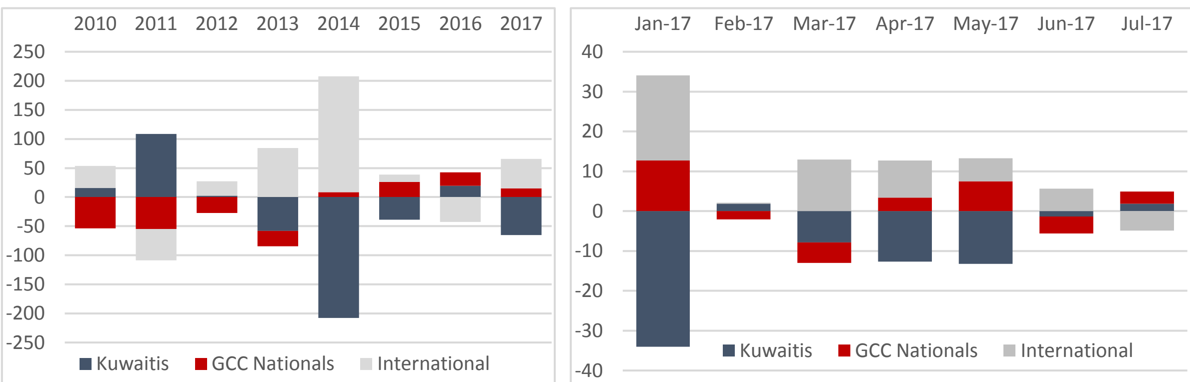


Source: Boursa Kuwait, NBKC

In terms of fund flows to the market, it seems that international interest has picked up again in light of the solid performance around the end 2016. As mentioned earlier, Kuwait has been generally seeing weak performance over the past few years mainly due to the lack of meaningful catalysts that would drive the stock market. The reforms and organizational changes in the local stock exchange and the trading system, in addition to a few successful deals that were executed in the market during the year, seem to have revived interest to some extent.

Net foreign inflows to the market amounted to around KD 65 million during the first 7 months of 2017, KD 15 million of which came from the GCC while KD 50 million came from international investors. This compares to a net outflow of around KD 42 million of international funds during 2016.

Chart 3. Net Fund Flows to the Kuwait Stock Market by Nationality (2010-2017, monthly for 2017, KD Mil)



Source: Boursa Kuwait, NBKC

Effect of a FTSE inclusion

Despite the fact that technical issues on country-level inclusion criteria seem to have been resolved, there could be an issue with stock eligibility. Should stock liquidity be measured in strict compliance with the documented criteria presented earlier and based on the 12-month trading data ending 30 June 2017, the number of companies that would qualify would not meet the minimum requirement for index construction of three constituents and this is why the Qatar scenario becomes more likely. In such a scenario, liquidity will be tested at half weight and inclusion in the FTSE EM index will be done in two tranches of 50% each.

It is important to note that at this point and given the information available, we can only speculate and present scenarios on the actual outcome of the September meeting.

According to estimates published by both Arqaam Capital Research and EFG Hermes in August 2017, the weight of Kuwait in the FTSE EM + China A All Cap Index will be around 0.5% with total inflows ranging from around USD 455 million to USD 740 million. This is the equivalent of around KWD 137 to 220 million. Both firms believe that FTSE would follow a phased approach in the inclusion in the same way that Qatar was promoted from Frontier to Secondary Emerging.

In terms of expected flows on a market level, given current liquidity averages of around KWD 300 million per month, the expected flows should have a significant effect on price levels especially when speculative money is added to the equation. The beneficiaries of such flows, however, will only be the names that would be included in the index, while the magnitude of the movement in individual stock would depend on its liquidity level, its weight in the index, and whether the inclusion would be phased or not.

The bottom line is that there are still too many unknowns to be able to gauge exactly the effect of the inclusion on the Kuwaiti stock market with any degree of certainty. What is almost certain, though, is that the actual inclusion will happen around 12 months after the official inclusion announcement, given historical precedents. This means that if the announcement were to happen by the end of September 2017, the inclusion would be in September 2018.

Again, given the example of Qatar, the market saw a pick-up in performance around the announcement date, then another pick-up in the two to three months leading to the date of inclusion of each of the two tranches. We believe it is likely for Kuwait to witness a similar behavior absent any other factors that could be affecting the market at the time.

Appendix A. Quality of Markets Matrix

Criteria	Developed	Advanced Emerging	Secondary Emerging	Frontier
World Bank GNI Per Capita Rating				
Credit Worthiness				
Market and Regulatory Environment				
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	X	X	X
Fair and non-prejudicial treatment of minority shareholders	X	X		
No or selective incidence of foreign ownership restrictions	X	X		
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	X	X	X
Free and well-developed equity market	X	X		
Free and well-developed foreign exchange market	X	X		
No or simple registration process for foreign investors	X	X		
Custody and Settlement				
Settlement - Rare incidence of failed trades	X	X	X	X
Custody-Sufficient competition to ensure high quality custodian services	X	X	X	
Clearing & settlement - T+2 / T+3	X	X	X	X
Settlement - Free delivery available	X			
Custody - Omnibus account facilities available to international investors	X	X		
Dealing Landscape				
Brokerage - Sufficient competition to ensure high quality broker services	X	X	X	
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	X	X	
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	X	X	
Stock Lending is permitted	X			
Short sales permitted	X			
Off-exchange transactions permitted	X			
Efficient trading mechanism	X			
Transparency - market depth information/visibility and timely trade reporting process	X	X	X	X
Derivatives				
Developed Derivatives Market	X			

Source: FTSE

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