INVESTMENT STRATEGIES

Growing opportunities for investors in Middle East

An efficient way of gaining access to the Middle East's equity markets is the key to a successful investment strategy in the region. Sharia compliant investment structures and participation certificates present attractive solutions writes Frederico De Palma

With Middle Eastern equity markets outperforming European and US markets by double-digits over the last year, opportunities to profit from this trend remain popular. Key to a successful Middle Eastern equity investment strategy is evaluating the market opportunities and determining the most efficient ways of gaining access to those with the highest performance potential. Sharia-compliant investment structures and participation certificates present attractive access solutions.

TARGET COUNTRIES

Equity investors tend to focus their attention within the Middle Eastern region on the markets that form the Gulf Cooperation Council (GCC), namely Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain and Oman.

Economic factors such as high income per-capita, exchange rates linked to the US dollar and the historical economic concentration on a limited range of sectors are common themes that permeate the GCC countries.

Middle Eastern equity markets have been historically restrictive to foreign investment, limiting to a varying extent the degree of direct investment by foreigners.

Recent evolution in regulatory framework, coupled with an increasing inclination towards accessing international sources of capital, are generating growing opportunities for foreign investors. A general propensity to liberalise market ownership and improve corporate transparency is accelerating the active involvement of global financial institutions in the region. The evidence is that domestic liquidity is being augmented by the inflow of international investors, with traditional funds and hedge-funds more and more involved in the market.

OPPORTUNITIES

The Middle East is home to some of the world's top oil and gas exporters and, in an environment characterised by record commodity prices, this factor represents a massive source of growth. The inflow of liquidity is being increasingly invested in the domestic economies, supporting and stimulating all key sectors of production and service, in particular the infrastructure sector.

Strong regional liquidity and generalised economic and population growth have led to an increasing demand for financial services in a environment characterised by a high level of protectionism. Retail, corporate and investment banking activities have received a positive impetus from this accommodating environment.

Telecommunications have experienced growth in terms of penetration and usage and have benefited from rising tariffs.

The real estate sector is experiencing development on an unprecedented scale, with

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numerous large-scale regional developments. The sector benefits from rapid population growth, low interest rates, improving regulation for property transfer and a growth of mortgage banking products.

Middle East markets tend to be less influenced by global equity markets, maintaining a low correlation level and acting as a defensive haven during phases of equity volatility elsewhere.

EVALUATING THE OPPORTUNITIES IN LIGHT OF SOME KEY RISKS

Middle Eastern equity markets have a relatively limited history and they are still experiencing a phase of evolution. From a general economic perspective, the region's dependence on oil represents a powerful source of growth in light of current commodities prices. However, this could be a threat in the event of a sharp pullback in prices.

The Middle East is a high-margin operating environment and new players could enter the market, increasing competition and compromising the profitability of established companies.

Inflationary pressures in several countries of the Middle East could generate challenges for companies, endangering the competitiveness of the economy. The liquidity of the equity markets has improved but there is still a discernible lack of derivatives instruments as compared with other more developed markets. This can result in a lower efficiency in the management of trading strategies based on leveraged, short or hedging positions.

SHARIA COMPLIANT INVESTMENT

There has been a surge in demand and development of investment products compliant with Sharia principles. These structures have become more flexible and innovative, enabling investors to gain exposure to various financial engineering techniques, underlying assets and pay-off profiles.

Ongoing cooperation between Scholars and investment banks is facilitating the continued development of tailored Sharia compliant products, preserving the liquidity and efficiency of traditional investment instruments.

ACCESS TO THE MARKET

For foreign investors, there are several ways of accessing the Middle East equity markets, the most popular being through mutual fund holdings and participation certificates. Global Depository Receipts are also available in certain parts of the market but their liquidity can be extremely low.

Buying actual equities provides direct access to the markets but can be difficult. Equities trading requires local custodian and brokerage accounts, with the associated costs of set-up and execution. In addition, ownership restrictions limit foreign trading opportunities.

Mutual funds are a simple way of gaining access to Middle Eastern equity markets and, specifically, to the fund managers' investment expertise. While benefiting from economies of scale

Local markets snapshots

Saudi Arabia
Saudi Arabia is the largest Middle East country in terms of population and territory and is home to the biggest oil reserve in the world. The equity market has the highest capitalisation of the Middle East region but remains the most insulated within the region, restricting direct foreign ownership to GCC residents only.

Kuwait
Second largest equity market of the region in terms of market capitalisation. The Kuwait equity market has experienced historically a low direct foreign ownership as a result of uncertainties related to capital gain taxation.

UAE
UAE represents the main centre of trade and finance for the region, with two separate equity markets, Dubai and Abu Dhabi.

Qatar
With the highest GDP of the region and population growing at an intense rate, the Qatar equity market is less open to foreigners as compared with other GCC peers because of foreign ownership restrictions.

Bahrain
Bahrain is the smallest Middle East country in terms of territory, population, oil and gas reserves. The equity market is relatively small and has limited liquidity.

Oman
Oman is the smallest equity market in the Middle East, with the majority of its capitalization represented by financial companies.

in terms of investment management and trade execution, the investor gives up the opportunity to define an allocation that best suits their risk/reward profile.

For investors seeking more direct control than afforded through mutual fund holdings, Global Depositary Receipts (GDRs) are an easier way than cash equities for foreigners to access the Middle Eastern market.

These financial instruments are negotiable certificates which)represent ownership of shares issued by a depositary entity.

They are traded independently from the underlying shares. However, they cover a restricted number of equities and their liquidity is still extremely limited.

PARTICIPATION CERTIFICATES

Participation certificates provide investors with the ability to access Middle East equity markets without purchasing stock but with the same economic exposure.

A participation certificate is typically a security issued by an investment bank which tracks the performance of a Middle Eastern equity.

The issuer of a participation certificate typically hedges its exposure to the investor by purchasing the local stock underlying the participation certificate. This means that any difficulties faced in directly holding a Middle Eastern security are absorbed by the issuer of the participation certificate, rather than the investor.

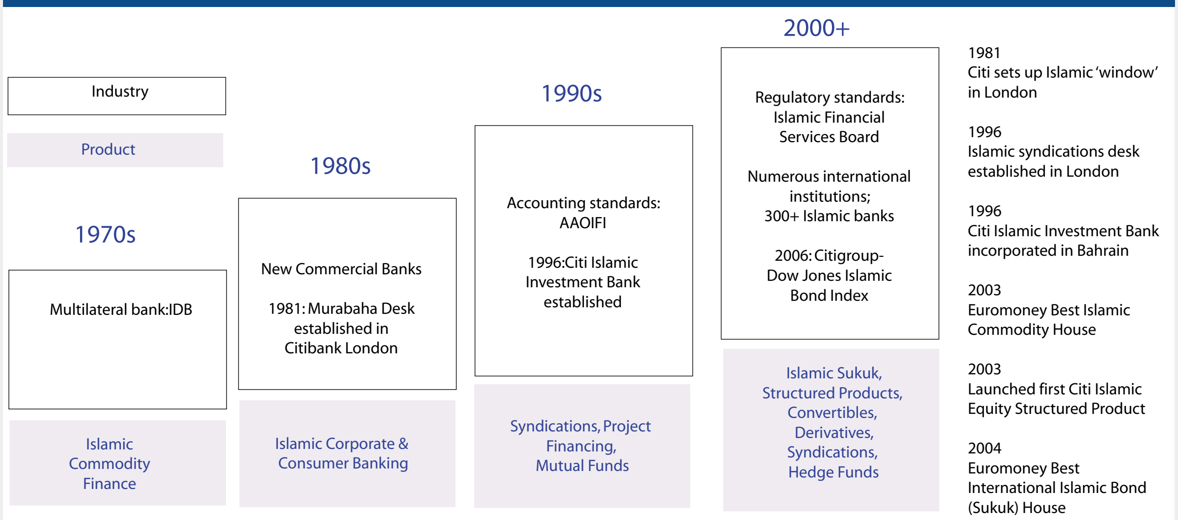
Figure 1 compares the main elements of a participation certificate and a local stock.

Frederico De Palma, Vice President, Equity Derivatives, Citi

Figure 1 : Product Comparison

	Participation Certificate	Local Stock
Maturity	1 year or more	Open-ended (no maturity)
Settlement	Euroclear / Clearstream	Local clearing house
Listing	Typically Luxembourg	Local stock exchange
Liquidity	Same as underlying stock	Varies by market
Currency of denomination	USD	Local currency
Dividends	Paid to the investor	Paid to the investor
Voting Rights	No	Yes

Figure 2: Citi's history in Islamic Banking



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