Perspectives On Investing In Middle Eastern Equities

Alissa Amico looks at how governance has evolved in the region and how foreign investors need to have a more profound understanding of this evolution.

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It is no secret that the growth of passive investing is threatening to overtake active asset management in the coming years. This trend, for the moment most pronounced in the United States (US), naturally also has implications for emerging markets where the largest foreign investors may be engaging less at a time when the need for their involvement may be at its highest.

Of the approximately USD $14 trillion tracking MSCI indices, close to USD $2 trillion are now allocated specifically to Emerging Markets (EMs). Of this growing EM pie, the Middle East region has thus far not featured prominently in the portfolios of international institutional investors. This is changing with the inclusion of Saudi Arabia – the largest market in the region – which is the eighth largest emerging market in the MSCI universe, expected to receive USD $30-40 billion of funds as a result of its inclusion.

Given the legacy of the region as a relatively restrictive investment destination, it is no wonder that the international investor community has little knowledge of regional markets, of which only a few, such as Turkey and Saudi Arabia, offer sizeable investment opportunities. This is changing, with large asset managers looking at the region more closely: BlackRock, for instance, has this year established a presence in Riyadh.

Yet, at least for now, the ownership structures and corporate governance of Middle Eastern companies remain an enigma for most foreign investors. This is reflected in their voting policies where the region is amalgamated with other regions such as Europe or even Eurasia, leading to generic approaches to engagement which lack a nuanced understanding of the region's corporate governance structures and regulatory approaches.

Foreign institutional investor understanding of strategy and governance of Middle Eastern companies is limited due to their relatively small investments in the region to date, as well as still lacking corporate disclosure and analyst coverage. For instance, our work in Egypt has demonstrated that only 10% of listed companies were followed by analysts, whereas close to two-thirds of firms had no coverage whatsoever.

A more profound understanding of how governance has evolved in the region is required for foreign investors to play an active role as stewards. The first corporate governance regulations emerged in the region almost 20 years ago, with the primary objective of addressing pressing challenges such as insider

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dealing and market manipulation that contributed to a steep decline in the Gulf markets in 2006.

Since then the speed of change in capital market legislative and institutional reform in the region has been significant, with the establishment of securities regulators in all markets which have swiftly introduced corporate governance codes for listed companies. In Saudi Arabia, the UAE, Egypt and other countries these codes have been revised following the update of the OECD Principles in 2017 and to reflect lessons learned domestically.

The result is that today virtually all markets in the region have robust governance regulations, comparable to other emerging markets. GOVERN's benchmarking of regulations across the region shows convergence in regulatory approaches across parameters such as the separation of CEO and Chair roles, the establishment of board committees and the introduction of board secretary and investor relations functions.

Indeed, corporate governance rules in some countries of the region are stricter than in other markets.

In countries such as Saudi Arabia and Kuwait, for example, a number of key governance code provisions are mandatory, in addition to comply-or-explain recommendations. Few investors are aware that issuers in Oman are required to have a fully non-executive board, or that the Audit Committee in Saudi Arabia is appointed by the company's shareholders.

At the same time, foreign institutional investors need to appreciate the particular governance risks associated with

investing in the region's companies, such as concentrated ownership structures with overlapping controlling shareholders. As such, they need to be cognisant that applying boilerplate engagement policies in the region may lead to less than meaningful outcomes.

Executive and board remuneration for instance, a key focus in the international governance debate since the financial crisis, is a perfect example of an issue which is not a major concern in the region. As most companies in the region are controlled, board representatives who are often also major shareholders tend to be compensated in dividends, not board fees. In addition, board remuneration in markets such as Saudi Arabia and a has been capped by law, with the result that in high risk sectors it is not remuneration but finding competent directors that represents the most significant challenge.

A number of areas which have received much attention in the investor community, and hence in the ICGN's work, are now starting to receive attention in the region. For example, the global investor community's increased argument for a one-share-one-vote structure following Snapchat's issuance of non-voting shares and the Hong Kong Stock Exchange's recent move to allow multiple class shares, is now relevant in the region where regulators are mulling over the introduction of multiple voting shares to attract families to list.

From the perspective of investors, arguably the most pressing challenge, apart from dealing with conflicts of interest, remains inadequate disclosure. While disclosure has improved from the perspective of English language reporting and its comparability has been facilitated by the introduction of XBRL, it lags from the perspective of environmental, social and governance reporting and integrated reporting. In our survey of market participants in the Egyptian Stock Exchange, less than 10% considered that significant disclosure-related progress has been realised in recent years.

It is little wonder that investors in the region find reporting uninformative. Corporate governance reports, required in most of countries in the region, remain boilerplate, essentially summarising the requirements of national governance codes. Board reports rarely deal with strategic and risk management priorities and do not link with reported financial performance risks even in blatant cases when provisions for liabilities are made.

Moreover, boards in the region are not yet actively cultivating links with the foreign institutional investor community, leading to the lack of a meaningful exchange between boards and investors, either through periodic corporate reporting or an ongoing investor relations process. This is slowly changing with the introduction of a requirement to appoint a dedicated investor relations professional in several markets, such as the UAE and Saudi Arabia.

In the Gulf, the tide is changing with the economic slowdown resulting from a decline in hydrocarbon revenues. Boards and executives are starting to feel compelled to engage with investors now that prohibitive investment restrictions have been liberalised in key markets such as Saudi Arabia, the UAE

and Qatar. Companies in Turkey, which has seen a major outflow of portfolio investment, also need to be more compelling in a more volatile economic context.

These dynamics are creating a fruitful soil for foreign investors to engage with the issuers on key priority topics. However, the foreign investor community needs to recognise that it is treading in unchartered territory since domestic institutional investors in the largest regional markets in the Gulf – mostly sovereign actors such as sovereign wealth funds (SWFs) or public pension funds – have been largely passive as owners.

While governance requirements for issuers have seen a watershed change, regulators in the region have not yet introduced stewardship recommendations. In part due to the political pressure created by the Santiago Principles for SWFs to remain apolitical, domestic sovereign investors have remained inactive, except in companies where the State is a significant shareholder with a possibility to nominate board members.

The opportunity is, therefore, for foreign investors to work with their peers in the region to gain a better understanding of local markets and their challenges, while sharing their stewardship experience and know-how in the region and beyond. Insofar as Middle Eastern sovereign actors are increasingly expanding their investment footprint globally to markets where they have limited experience, this exchange experience can prove productive beyond the region's borders.

Alissa Amico is an internationally recognised expert specialising in corporate and economic governance. She the founder and director of a think-tank and advisory firm GOVERN, recognised for its work with governments and companies on the design of governance regulations and structures. Prior to founding GOVERN, Alissa launched the OECD's regional project in MENA, in particular developing and subsequently managing a programme on governance in the region.