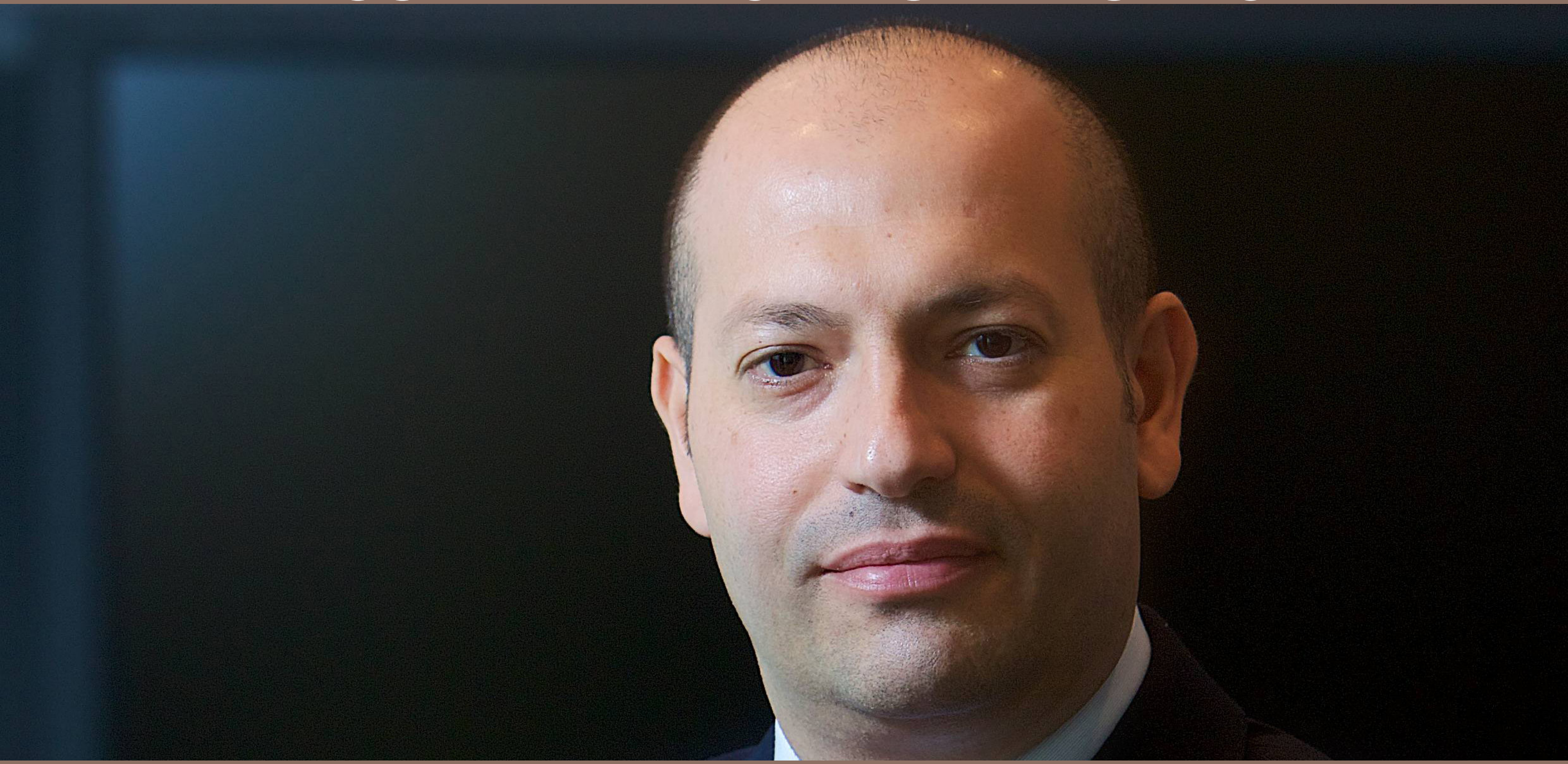
SETTING THE TONE FOR LISTING GCC STATE OWNED ENTERPRISES – AN ASSET MANAGER'S PERSPECTIVE



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A State Owned Enterprise (SOE) is a business that is wholly, or partially, owned by a government. Although SOEs are ostensibly commercial organisations, they are often managed with a broader mandate to help develop economies, provide essential services and create employment opportunities.

Over the past fifty years SOEs have been an important tool for managing economic, political and social development, particularly, though not exclusively, in emerging countries. They have been used to incubate industries, redistribute wealth, correct market failures and even promote national agendas on the world stage. They typically account for a significant proportion of economic output, employ thousands of citizens and can be absolutely critical in the provision of certain services that might otherwise not be supplied, or perhaps not at affordable prices.

The rationale for the creation of SOEs is clear but riddled with risks including the potential for the misallocation of scarce resources, the misuse of public funds, higher fiscal burdens, and the scope for political interference and excessive bureaucracy. In aggregate, the proliferation of SOEs across several sectors can also encroach on the free market and raise all sorts of costs that are detrimental to economic competiveness over the long term.

By virtue of the obligations that arise from their virtual monopoly of the region's natural resources, as well as the paternalistic nature of local societies, governments across the Arabian Gulf have been extensively and intricately involved in overall economic activity both directly and through SOEs. Some of these entities whose ownership takes various forms, including direct shareholding by ministries, sovereign wealth funds, state corporations or even government sponsored pension plans, have been used to channel subsidised products and services, including food, fuel and domestic utilities to citizens.

In many cases these SOEs have been nurtured under public ownership but then listed on the national stock exchanges, partly so that local investors can share in their success, and partly so that the companies can tap the capital markets for funding, and benefit from the discipline imposed by the marketplace. As a result, government ownership in listed companies is substantial, and accounts for a significant weighting in the local stock indices.

The Saudi Tadawul All Share Index (TASI) currently consists of 176 companies with the largest 27 companies accounting for about 72% of the adjusted index weighting. The market value of these companies is around SAR 1,270 billion ($338 billion) of which approximately half is held by government institutions including the Public Investment Fund, the General Retirement Organisation, the General Organisation for Social Insurance and SABIC (which is 70% government owned).

Saudi Arabia's Public Investment Fund alone holds declared stakes worth over SAR 390 billion ($104 billion) in 19 locally listed companies.

Companies that in some cases started off as relatively small providers of important services such as electricity and power, telecommunication and financial (banking) services, have mushroomed into enormous organisations. Many of these have grown well beyond their initial remit and expanded into other sectors or to new geographies. The Saudi Telecom Company, for example, in which government related entities hold over 83% of outstanding shares and that retained a monopoly in its domestic market until 2007, now operates in Kuwait, Bahrain, India, Malaysia, Turkey, South Africa, Lebanon and Jordan. It continues to provide fixed line and mobile services but has expanded into internet services, technology investments and on-demand television.

Despite such exponential growth governments have barely diluted their holdings over recent years. Four of the largest five listed Saudi banks continue to have a significant government shareholding, while in the United Arab Emirates sovereign ownership in various guises dominates the shareholder register, and the Qatar Investment Authority appears as a double-digit shareholder in the largest local banks.

Such ownership is not necessarily a drawback to those institutions or indeed to other shareholders, after all, they may benefit from implicit government support, preferential dealings and access to key policymakers. SOEs may also profit from advantages in obtaining finance, particularly in times of tight liquidity, and in the procurement of public contracts.

However, such close links can raise questions about conflicts of interest, the absence of a level playing field for private sector competitors and the oversight of related party transactions.

Governments can also offer SOEs excessive protection so that it hinders economic development, promotes inefficiencies or imposes higher burdens on society. While still subsidised to the consumer, the cost of producing electricity and water across the Gulf remains arguably higher than might be expected in a more competitive environment, while certain telecom services are unavailable or prohibited to the detriment of users.

With the days of plenty now seemingly behind, policymakers across the GCC are taking a hard look at ways to develop and diversify their economies, and reassessing the role of SOEs. Their urgency is a function of deteriorating public finances but also a belated acknowledgement that economies have continued to operate under an archaic framework more suited to the last century than the present.

Many proposals have been articulated in publically announced, and fairly detailed, plans that target lofty objectives over the coming years. Saudi Arabia's Vision 2030 is perhaps the best known, but each country has its own variation. The expectation is that governments will offload, partially in most cases, stakes in a large number of businesses from the strategically important oil and gas sectors but also the transportation, healthcare and education industries. It is difficult to estimate the value of companies that will be privatised over the next few years, but it is likely to be substantial and may dwarf the value of existing listings on the regional exchanges.

In order to meet the increase in supply of shares it will be essential to engage with foreign investors and attract international capital that is typically risk averse and increasingly sensitive to matters of governance in the emerging economies. Indeed, institutional investors managing over $60 trillion have signed up to the UN's Principles for Responsible Investing which requires them to incorporate Environmental, Social and Governance (ESG) factors into their investment processes.

Investors will be keen to understand the process by which conflicts that may arise between the profit maximizing objectives of private companies and the national, or indeed international, interests of governments will be managed. Can a privatized healthcare system treat poor or uninsured patients? How will a nominally private oil company manage obligation to industry associations and international organisations?

The point at which companies cease to be SOEs and become private companies in which the government is simply another shareholder can be difficult to establish, especially in the emerging markets. The size of shareholding is perhaps the most obvious yardstick except that it is not unusual for influential shareholders to effectively control companies through a relatively small stake.

Nonetheless, corporate governance of SOEs in the emerging markets has taken giant leaps over the past twenty years as part of the trend towards globalisation and due to increased cross-border capital flows. In addition, governments across the Gulf can rely on a reasonably robust track record based on their management of existing holdings in listed SOEs. A positive evaluation of governments in their role as leading shareholders in existing listings can provide a huge boost to prospective new listings. Saudi Arabia's Sabic, for example, has often been lauded as a world class petrochemical company even though it remains largely under government ownership.

From an asset manager's perspective investing in privatisations may be attractive if potential commercial, operational and financial risks can be mitigated and if there is confidence in the role of market regulators, stock exchanges and the financial authorities.

The capital market discipline and regulatory governance standards imposed on listed SOEs is the first line of protection for shareholders. However, governments have an additional onus to separate their ownership from any policy making or regulatory function that may have influence on the businesses.

From the SOE's vantage, preparing for a stock market listing should involve improved reporting and disclosure, safeguards against continued government intervention and a clear and transparent process for nominating qualified and independent board members, and establishing a credible evaluation and remuneration process for managers and directors. Protecting minority shareholders by promoting their active participation in shareholder meetings and representation on the board should also be enshrined in the constitution. And while a high degree of transparency should ease many concerns, it is important to detail conflict resolution mechanisms. Ultimately, however, it is really about implementation and in this regard the capital markets have become increasingly adept at sorting out effective commitment to good governance from cosmetic ones.

The advantages of good governance, including easier and cheaper access to capital, better operational performance and higher profitability, as well as improved valuations for listed companies, are widely recognised.

The listing of Saudi Telecom Company in 2005 was a massive catalyst for change and improvement at the company but also across the industry. Within a short period the company managed to shed its antiquated image as a bureaucratic monolith, riddled with vested interests, fiefdoms and inefficiencies to become a modern and customer friendly service provider that helped set industry standards across the region.

Although the rationale for continued government ownership of mature and increasingly international companies is questionable, there are examples of successful SOEs that are entirely government owned, such as in the massive and hugely successful airline industry. These companies would be unmanageable and probably unprofitable without a significant degree of good governance.

As such, there is reason to be optimistic that the privatisation of state owned companies across the Arabian Gulf will find widespread investors interest and that the relatively healthy state of corporate governance in the region will be an important contributor.