Institute of Banking Studies Research »

Analyzing Listed Kuwait:
Growth outlook for Corporate and Investment Banking

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APRIL, 2017

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Table of Contents

Section **Page**

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EXECUTIVE SUMMARY

The current market for corporate and investment banking in Kuwait is reflected in low loan growth, low primary and secondary activity in the stock market and few opportunities in debt capital markets. This study found that:

- The number of capital raising exercises and new listings on Boursa Kuwait in 2014 and 2015 remained below the level in the six years leading up to and including 2008.
- Average daily turnover in the stock market was 86.1 percent lower in 2015 than in 2005.
- Only 11 Kuwaiti companies had bonds or sukuk in their funding structure at the end of 2015. There exists no formal debt/sukuk capital market in Kuwait.
- While profitability in both emerging and developed markets, as measured by return on equity, was around 10 percent in 2015 for all listed companies, it was 6.2 percent for listed Kuwait, in aggregate, excluding banks and insurance companies.
- In 2015, net profit for 27 out of 82 listed nonfinancial companies was affected, both positively and negatively, by more than 25 percent due to investments in securities and real estate. A lack of focus on core activities, combined with an average free float 36.8 percent, may discourage institutional, and especially foreign, investors from investing in Kuwaiti stocks.
- Debt-to-equity is high in Kuwait. At the end of 2015, it was 84 percent for listed Kuwaiti companies (ex-banks) in aggregate, versus 46 percent for all emerging market listed companies. Of total corporate borrowings from the banks, 37.8 percent have a less than one year duration.
- Capex levels in 2015 are low compared to emerging and developed markets, suggesting under-investment in nonfinancial assets in Kuwait.

Slow corporate loan/finance growth and low levels of capex over the past few years may imply an increase in both capex and demand for borrowing in the coming years. Banks should be working with their clients now to explore potential funding options, both commercial and investment banking based.

At the same time, Kuwaiti banks' corporate advisory departments should be working with their clients to help them re-focus on core activities and lower leverage in advance of any future need to raise finance to fund investment activity.

Finally, the banks should work with regulators to discuss the development of a debt and sukuk capital market in Kuwait, with all its attendant benefits. All parties should consider conducting a formal review that encompasses as assessment of the ease of doing business in Kuwait as well as the necessary infrastructure that would be required for an active primary and secondary market for debt.

INTRODUCTION

The purpose of this study, written at the bequest of the IBS Research and Studies Committee, is to assess the attractiveness of Kuwait's capital market to both domestic and foreign investors, thereby highlighting opportunities for the Kuwaiti banking community to further develop investment banking operations to complement their current focus on commercial banking. At the moment, the financial system is predominantly bank-centric.

Increasing use of capital markets to raise finance, known as financial disintermediation, is a hallmark of a country's financial development. There are many associated benefits:

- The more diversified and varied the ways lenders and borrowers can be brought together, the more likely it is that capital will be forthcoming to medium and large sized corporations, looking to invest in new projects.
- Liquid debt capital markets provide a benchmark of interest rates across a spectrum of time horizons enabling a more efficient and rational allocation of capital in the economy.
- Banks can diversify revenue streams and risk in their respective banking books.
- Local investors are able to diversify their domestic portfolios away from equities and real estate.
- Government can issue KD-denominated bonds to domestic nonbank investors, providing an additional local source of non-inflationary funding.
- Combined with a reinvigorated equity capital market, a Government can look to list state-owned enterprises, both raising money and injecting private sector discipline into day-to-day management.

During our research, it became apparent that there are significant headwinds facing investment banking activity in Kuwait, as well as the broader banking industry. No doubt, for instance, a weaker domestic economy, driven by lower oil prices has had a negative impact on corporate demand for external funds.

Even so, rather than focusing on the macroeconomic environment and how it may be impacting credit growth, this study has focused on a limited number of structural balance sheet issues that may be inhibiting debt and equity capital market development in Kuwait; as well as causing corporate loan growth to be weak.

This study is predicated on the belief that more vibrant debt and equity capital markets, supported by the commercial banks, are critical to Kuwait successfully achieving its 2035 vision, as set out by His Highness the Amir of Kuwait, Sheikh Sabah Al Ahmad, "aimed at transferring

Kuwait into a financial and commercial hub attracting investment, where the private sector leads economic activity".[1]

This study is organized into three sections:

- *Section 1: The state of the Boursa Kuwait.*
  Background on Kuwaiti capital markets is provided by examining: 1. Primary and secondary stock market performance and activity over the past few years; 2. Bond issuance.

- *Section 2: Corporate performance and governance.*
  We examine the attractiveness of Kuwaiti corporates to investors, both domestic and foreign, based on their profitability and focus on core activities. In effect, we assess the demand for Kuwaiti securities and funding instruments from institutional investors.

- *Section 3: Funding structure.*
  We examine the funding requirements of listed Kuwaiti corporates, with a view to assessing both the potential for growth in traditional financing operations and via bond/sukuk issuance. Essentially, this section focuses on the potential future supply of Kuwaiti funding instruments.

SECTION 1: THE STATE OF BOURSA KUWAIT

Section 1.1: Primary activity in the equity market

It is often overlooked that the stock market has a dual role. Most commonly, people associate equity markets with their *secondary* role, enabling investors to buy and sell stocks in listed companies.

However, a stock market also enables companies to raise money to fund new investments, or for founding individuals and institutions to divest of existing holdings. New listings, initial public offerings (IPOs), private placements and rights issues are *primary* stock market activities that speak to the health of a country's economy, stock market and corporate sector. When economic confidence is high, stock markets tend to perform well, and, more often than not, primary market activity will increase.

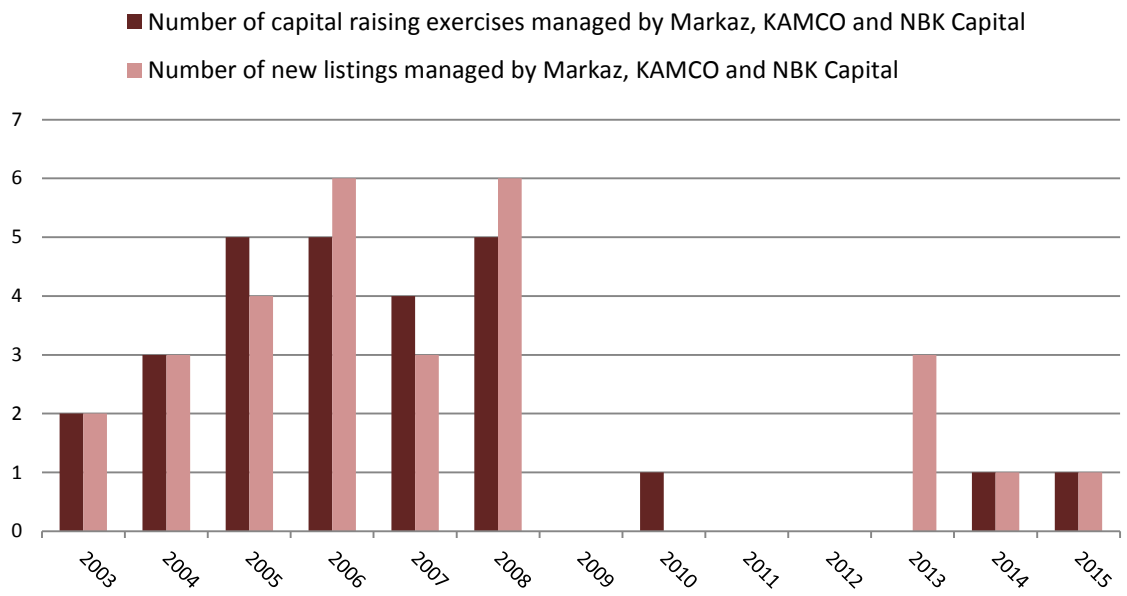
While it is common to judge the state of a particular stock market by looking at its recent performance, it is equally valid to evaluate it on the extent to which it facilitates primary market activity.

Chart 1 below demonstrates that while there has been some primary market activity in the past three years, the level of activity recorded by three leading houses, Markaz, NBK Capital and KAMCO remains below the level experienced between 2003 and 2008.

Chart 2 below, which tracks the value of new capital raised on Boursa Kuwait through rights issues, IPOs and private placements tells a slightly more promising story. It should be noted, however, that the value of transactions in 2014 and 2015 relates to one company in each year respectively: Burgan Bank in 2014 (which raised capital largely in response to Basel III regulatory requirements) and Mezzan Holdings in 2015.

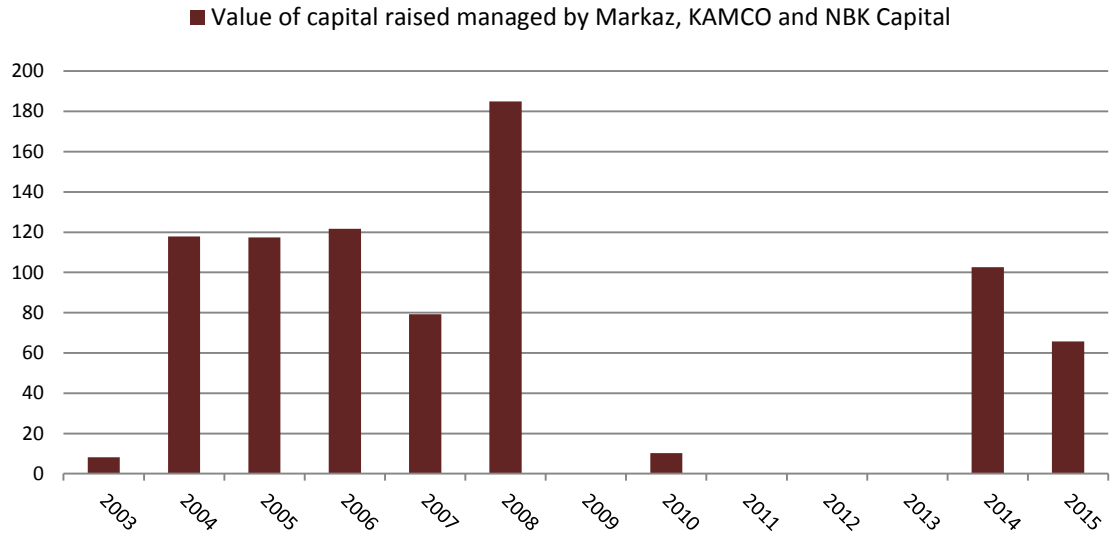
Taking both charts together, it is reasonable to conclude that primary market activity has remained muted since the 2008 global financial crisis and that, at least for now, the equity market is not being viewed particularly favorably by corporates as a place to list or raise fresh capital.

Chart 1: Equity capital market activity of three leading investment banks remains muted



Source: Markaz, NBK Capital, KAMCO company websites

Chart 2: Value of capital raised still low by historic standards and reliant on single issuers



Source: Markaz, NBK Capital, KAMCO company websites

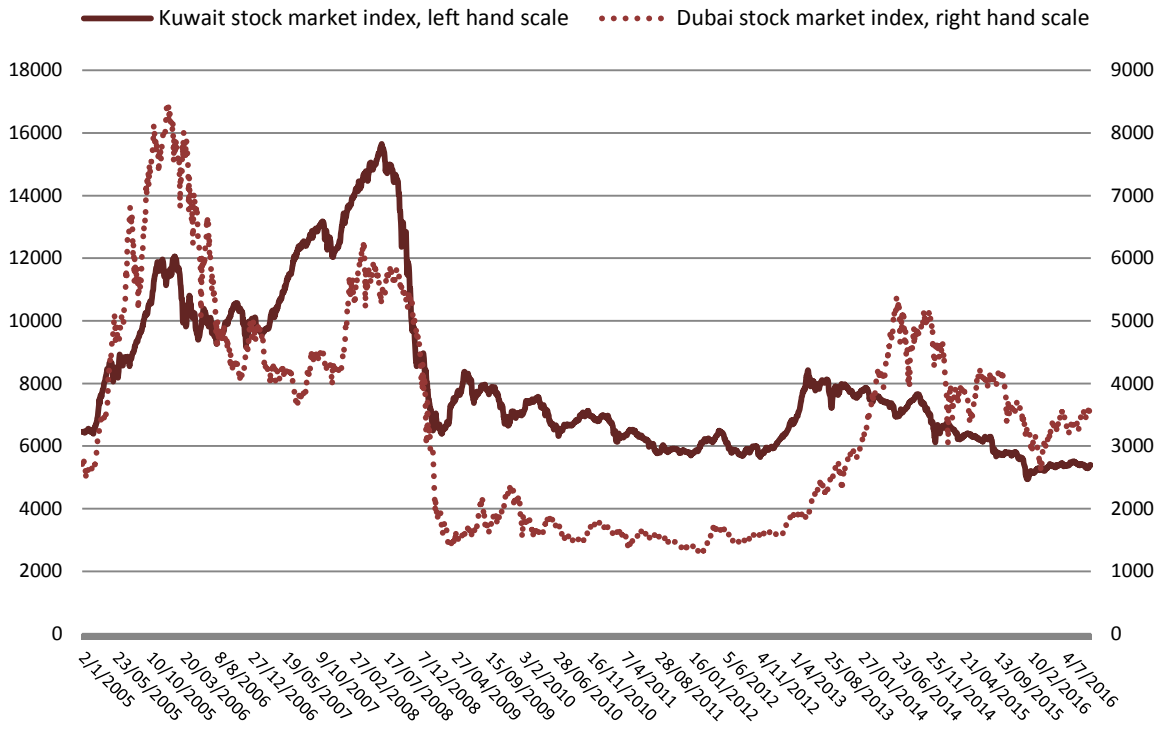
Section 1.2: Secondary activity in the equity market

Chart 3 tells a similar story; since the financial crisis, barring a small bounce in 2013, the index has continued to wane, with seemingly little appetite among investors for a significant reallocation of funds to Kuwaiti equities.

The inclusion of the Dubai Financial Markets General Index in the chart provides regional context. While the Kuwait stock market is not unique in remaining well below the highs reached prior to the financial crisis; because of its higher volatility, the Dubai market has at least provided investors with more opportunities to make significant gains since the lows. Whereas the Kuwait market is still testing new lows, as of writing the Dubai market is up around 250 percent from its low.

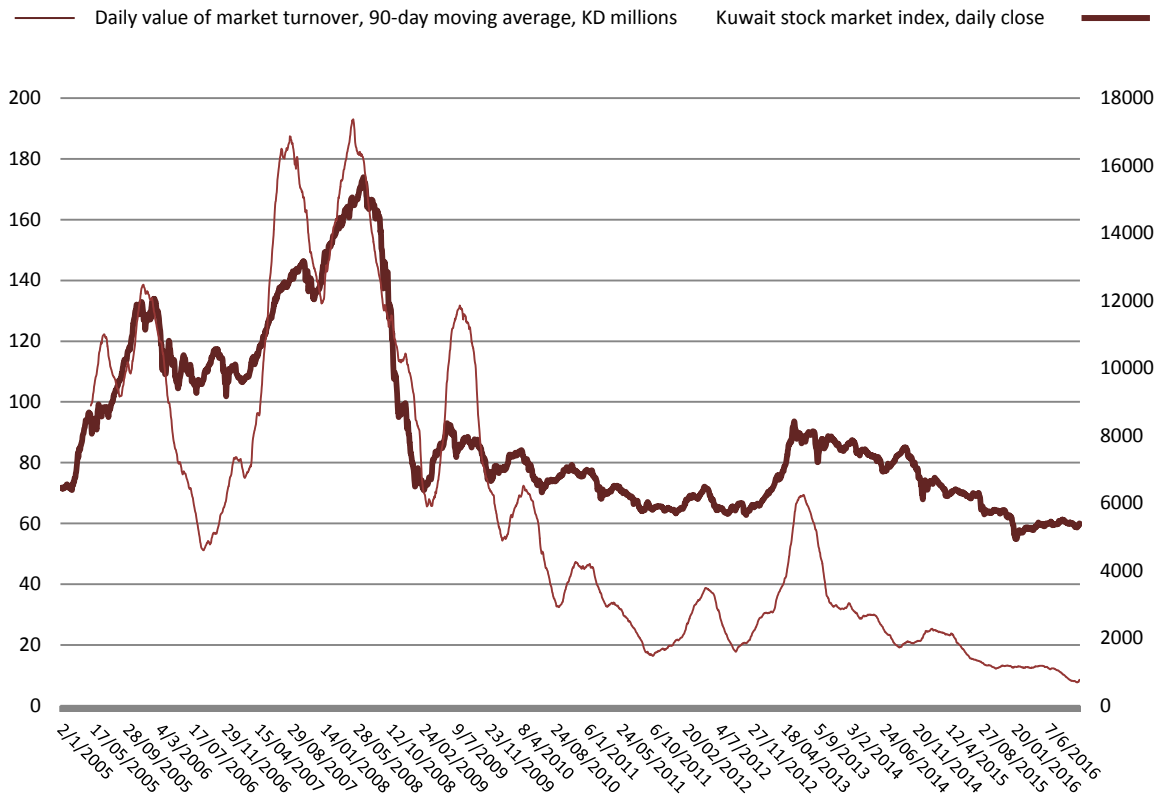
Perhaps more concerning than the stock market index is the level of daily turnover, which remains very depressed by historic standards. Chart 4 below shows the 90-day moving average for the daily transaction value of all listed equities in Kuwait. The value of daily trading is around one-tenth of what it was at the start of 2005.

Chart 3: Both Kuwait and Dubai stock indices well off 2008 highs



Sources: Boursa Kuwait, investing.com

Chart 4: Kuwait stock market: index and turnover low compared to past 10 years

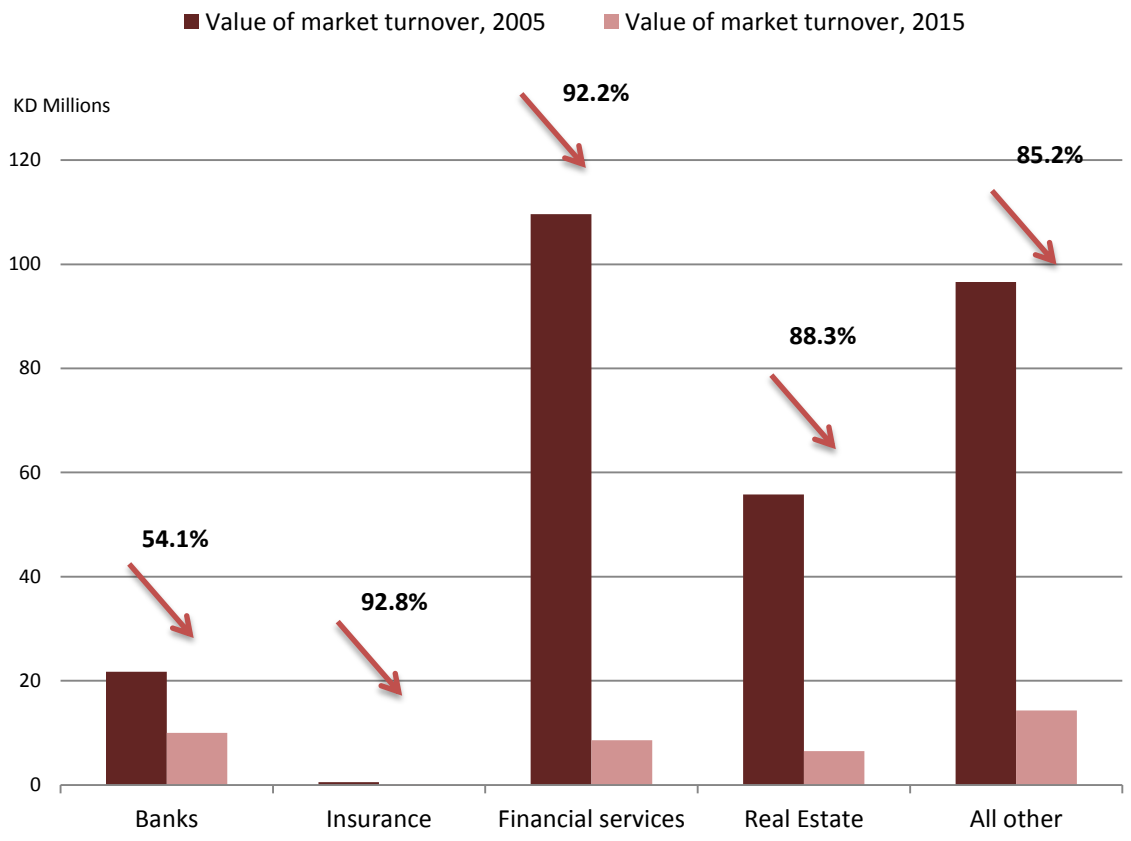


Source: Boursa Kuwait

Chart 5 below provides a sectoral breakdown of changes in market turnover. It shows, for instance, that the decline in the turnover of banking stocks has been significantly less than other sectors, by 54.1 percent comparing 2005 with 2015. It also shows that the financial services sector has been most impacted; turnover is down 92.2 percent in 2015 versus 2005.

Confidence in the financial services sector was clearly hit hard by the financial crisis, and this is reflected in the dramatic decline in turnover. All the same, other than the banks, all other market sectors have witnessed declines in turnover of 80 percent or more. In Sections 2 and 3 of this report we examine some of the potential reasons for declining turnover and some potentially corrective measures that might galvanize investor sentiment enabling a more vibrant market and active investment banking sector.

Chart 5: Financial services largest contributor to declining market turnover



Source: Central Bank of Kuwait

In the thin trading environment, market activity has focused on a limited number of companies. For instance, according to Boursa Kuwait data on November 1, 2016, out of 183 stocks available for trading, 75 recorded no volume at all, and 76 stocks traded a value of less than 50,000 KD. Only 20 stocks traded with a value of over 100,000 KD, making up 80.8 percent of the total value traded that day. The top 5 most traded stocks accounted for 49.5 percent of total trading value. The average value traded of these 5 stocks was 835,645 KD, roughly $2.8 million.

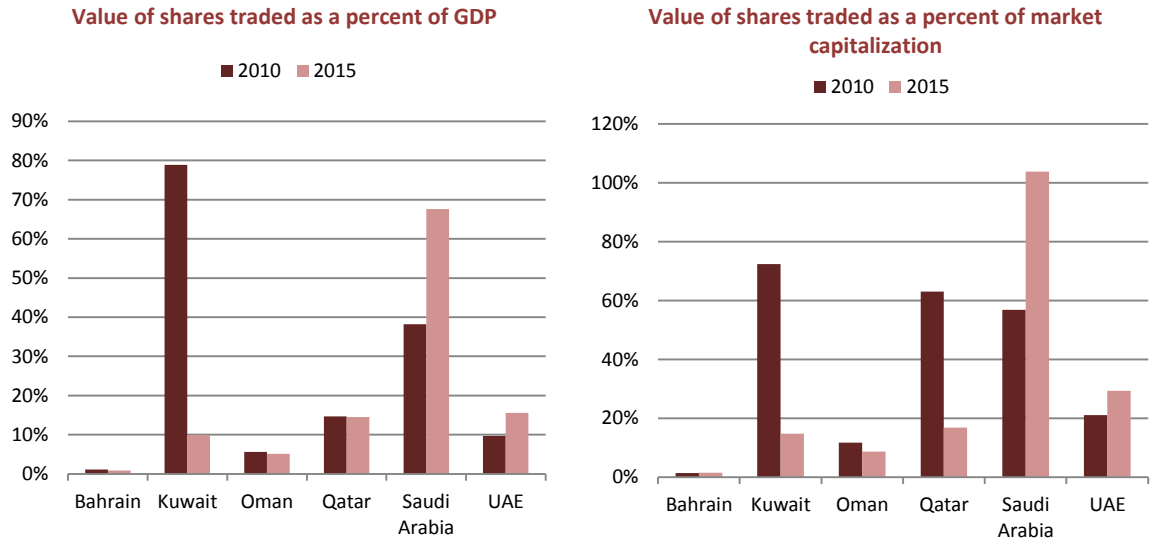
Foreign investors looking to take meaningful stakes in Kuwaiti companies are unlikely to be attracted to a market where the daily turnover of even the most active companies is under $3 million. After all, an investment of $20 million would dominate trading for almost 7 days.

Section 1.3: Equity market liquidity in a GCC context

While other GCC markets have performed badly since the financial crisis – see Chart 3 – as Chart 6 shows, Kuwait stands out from the rest of the GCC in experiencing heavy declines in market turnover.

These data points suggest that there may be more long-term structural, rather than cyclical, reasons for Kuwait's stock market malaise; discussed in Sections 2 and 3 of this study.

Chart 6: Kuwait market liquidity declines greater than GCC peers



Sources: Boursa Kuwait, Central Bank of Kuwait, Bloomberg, The World Bank[2]

Section 1.4: Debt capital markets

Currently Kuwaiti corporates are not able to issue KD-denominated bonds to local investors that can be subsequently traded in a formal secondary market. In the GCC, only Dubai and Oman have functioning debt capital markets; although Saudi Arabia is currently considering establishing one.

Having no domestic market does not preclude Kuwaiti corporates from issuing debt/sukuk securities. Moreover, some important figures in Kuwait, including the Chairman of Commercial Bank, believe that having a local debt market is a critical first step before sovereign debt can be issued internationally.[3]

As Table 1 shows, a number of Kuwaiti corporates do currently have outstanding international as well as KD-denominated bond issues. However, there are significant drawbacks to having no domestic bond market. Without one:

- It is more difficult to find buyers for new issues of KD-denominated bonds and pricing is likely to be higher.
- Issuers of tradeable debt are forced to accept currency risk or the costs associated with currency hedging.
- Smaller companies, which are less likely to issue international bonds, face constrained funding options.
- Kuwaiti investors are less able to diversify their domestic investment portfolio beyond equities and real estate.
- There can be no yield curve for Kuwaiti debt. In mature financial markets, yield curves provide an important tool for the pricing of risk, and for policy-makers to assess economic and market conditions.

Table 1: Small number of outstanding bonds of Kuwaiti corporates

Issuer	Size and currency	Issue date
Burgan Bank	USD 500,000,000	07/09/2016
Boubyan Bank	USD 250,000,000	10/05/2016
Gulf Investment Corp	MYR 450,000,000	14/03/2016
KIPCO	USD 500,000,000	08/03/2016
National Bank of Kuwait	USD 700,000,000	01/04/2015
Burgan Bank	USD 500,000,000	23/09/2014
Kuwait Energy	USD 250,000,000	23/07/2014
KIPCO	USD 500,000,000	30/01/2014
Gulf Investment Corp	USD 500,000,000	21/11/2012
Gulf Investment Corp	MYR 117,000,000	29/05/2012
Kuwait Projects (various)	USD 2,000,000,000	Not available
Kuwait Projects (various)	KD 229,249	Not available
Kuwait Finance Center (Markaz)	KD 22,000,000	19/12/2011
Housing Finance Co.	KD 2,575,000	2015
United Real Estate Co.	KD 60,000,000	24/06/2013
Alargan Real Estate Development	KD 21,131,621	11/4/2012

Sources: company financial statements, Cbonds database

As Table 1 shows, as of writing, there were only 11 institutions with outstanding bonds issues. The largest issuers are the banks. Both Burgan Bank and NBK have issued 'capital securities' for regulatory reasons. The remaining institutions are financial in nature, excluding Kuwait Energy.

Financial companies in particular should, in theory, view bonds as an important source of finance and as a useful place to invest excess liquidity, helping them to better match the duration of their assets and liabilities. Indeed, given that there are a large number of investment companies in Kuwait, both listed and unlisted, one would expect there to be strong interest in

establishing a debt market; and sufficient demand from the investment community for debt instruments. In short, the development of debt capital markets would provide local banks wanting to engage in or expend their investment banking services with significant opportunities.

In practice, however, corporate Kuwait continues to rely on the commercial banks for finance. Obviously, this reflects the lack of debt capital market infrastructure. It also reflects the low interest rates available to corporate borrowers. In 2015, according to data published by the Central Bank of Kuwait[4], 75 percent of all credit facilities were priced at under 5 percent, whereas the KD denominated fixed rate bonds issued by Kuwait Projects and Markaz were priced between 4.75 and 5.65 percent.

Relatively cheap commercial loans reflect competition among the banks for corporate customers and excess liquidity in the system. All the while these conditions persist, we would expect there to be little pressure to develop a bond market however beneficial it could be in enabling Kuwait to expand its role as a financial services hub.

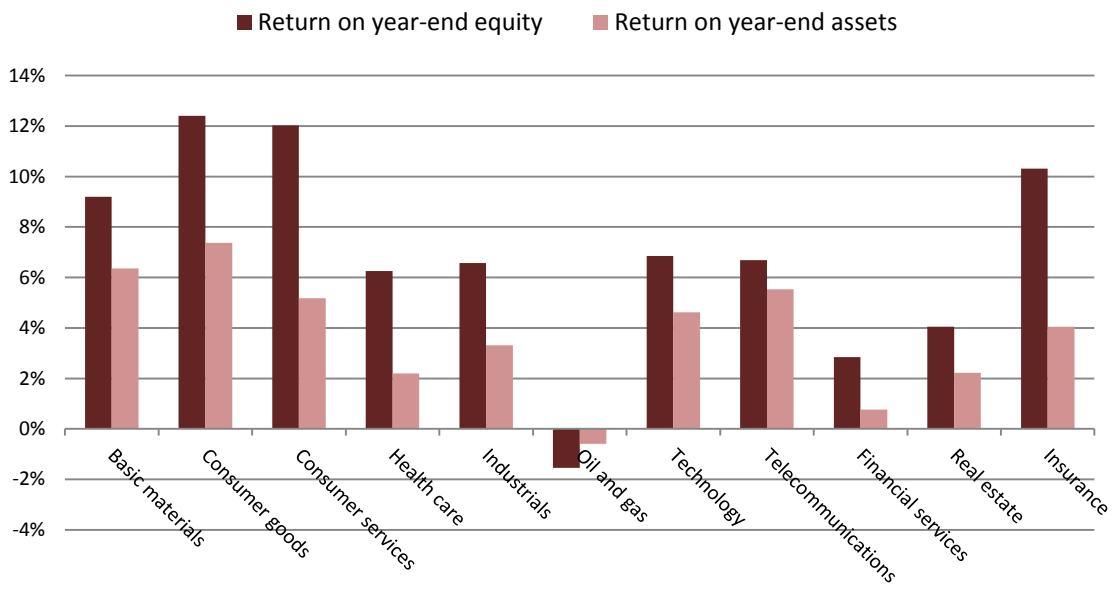
Even so, we recommend the banks to work with regulators to discuss the development of a debt and sukuk capital market in Kuwait, with all its attendant benefits. All parties should consider conducting a formal review that encompasses as assessment of the ease of doing business in Kuwait as well as the necessary infrastructure that would be required for an active primary and secondary market for debt.

SECTION 2: THE STATE OF LISTED KUWAIT

At the end of 2015, the Kuwait stock market, in aggregate, was trading on a price-to-book multiple of 0.96 times.[5] In other words, according to IBS calculations, the aggregate market capitalization of Boursa Kuwait-listed companies was roughly equal to its aggregate shareholders' funds. By way of comparison, at the start of 2016, the U.S. stock market was trading on a price-to-book of 2.5 times.[6] There are, of course, many factors that affect market performance, from the macroeconomic and political backdrop, to legal structure, trends in security returns, forecast industry returns and risk appetite. And many of these factors could account for the differential in performance between Dubai and Kuwait. However in this section we place special attention on key structural balance sheet factors that might explain why the market is trading at a low valuation.

In particular, low market valuations could reflect relatively low levels of underlying profitability and growth relative to investors' required rates of return.[7] Chart 7 provides some evidence that this is the case. Only two sectors (excluding banks and insurance companies) recorded a return on equity over 10 percent, while the aggregate ROE was 6.2 percent (again excluding banks and insurance companies). For comparison, the average ROE across all sectors in the emerging markets is around 10 percent.[8] In addition, with low oil prices and fiscal constraints, it is likely that investors' expectations of short to medium-term growth are low.

Chart 7: 2015 profitability levels generally disappointing



Sources: Bayanati, Company financial statements, Boursa Kuwait

Weak expectations of profitability and growth provides only a partial account of the problem, as stock market valuations also reflect investors' required rate of return, itself a function of interest rates, country risk (political and economic) and risk factors associated with corporate governance, among other factors.

In the following sections, we take a closer look at governance issues that may be weighing down investor sentiment in Kuwait, leading them to require a high rate of return (i.e. low prices) before considering significant asset allocation into Kuwaiti equities.

Section 2.1: Non-financial listed corporates

Table 2 shows that low valuations and low market turnover among nonfinancial Kuwaiti equities could reflect governance issues, such as a lack of focus on core business operations and a perception that outside shareholders have little chance to influence managerial decision-making. Both these factors are likely to act as strong disincentives to foreign investors and would continue to make it probable that Kuwait remains categorized as a 'frontier', as opposed to an 'emerging', market. (It should be noted that an upgrade from frontier to emerging market status would necessitate significant inflows of foreign capital.)

Table 2: How nonfinancial companies focus on noncore activities affects ROA, 2015

	Return on assets	ROA ex real estate, securities and associates (Core ROA)	Core ROA plus real estate and securities	Core ROA plus associates	Average free float
Basic materials	6.4%	9.5%	7.2%	7.6%	46.4%
Consumer goods	7.4%	9.9%	7.6%	9.5%	23.7%
Consumer services	5.2%	7.1%	6.1%	6.3%	38.2%
Health care	2.2%	3.0%	2.3%	2.9%	19.7%
Industrials	3.3%	3.1%	3.4%	2.9%	41.7%
Oil and gas	-0.6%	0.4%	-0.6%	0.4%	42.5%
Technology	4.6%	4.7%	4.6%	4.6%	38.5%
Telecommunications	5.5%	5.7%	5.5%	5.7%	43.6%

Sources: Bayanati, Company Financial Statements, Boursa Kuwait

Table 2 shows that non-core investments made by nonfinancial listed companies in Kuwait had a material negative impact on profitability in 2015. For instance, by stripping out assets and income related to investments in real estate, securities and associates, the consolidated basic materials sector's ROA increased from 6.4 percent, as reported, to 9.5 percent.

A comparison of column two and three shows that excepting one sector (industrials), all the other sectors reported worse profitability than they otherwise would as a result of their investments in real estate and securities. In some cases, the difference was marginal (technology and telecommunications), but in a majority of cases, the difference was significant.

Regardless of whether these investments increase or decrease overall profitability, out-sized non-core business investment portfolios introduce uncertainties for investors trying to forecast future earnings. In 2015, for instance, out of 82 listed nonfinancial companies, net profit for 27 of them was affected (both positively and negatively) by over 25 percent due to investment income from securities and real estate. Such investments also denote raised risk associated with so-called 'pyramid structures': falling stock market prices, for instance, by virtue of directly affecting profitability, can lead to more falls in the stock market, leading to worse profitability etc. etc.

Table 2 also shows that investments in associates had a similar impact on profitability in 2015. A comparison of columns 2 and 4 shows that there were only two sectors (oil and gas and telecommunications) where investments in associates had no impact on profitability. Of course, it is arguable that investments in associates represent a different kind of investment than those in real estate and securities; and that it is ultimately false to label them 'non-core' activities.

While this may be valid, it is important to note that external investors may view investments in 'associates' as a source of uncertainty. Unless the associate is separately listed, they have no access to underlying data and therefore are unable to accurately forecast the associate's future earnings. Nor, importantly, are they able to gauge from financial statements the role that the parent company has in an associate's management. Associate status, after all, is applied to a company in which over 20 percent of the stock is owned, but less than 50 percent. The management of the parent company may run the associate, or they may have little or no managerial control at all.

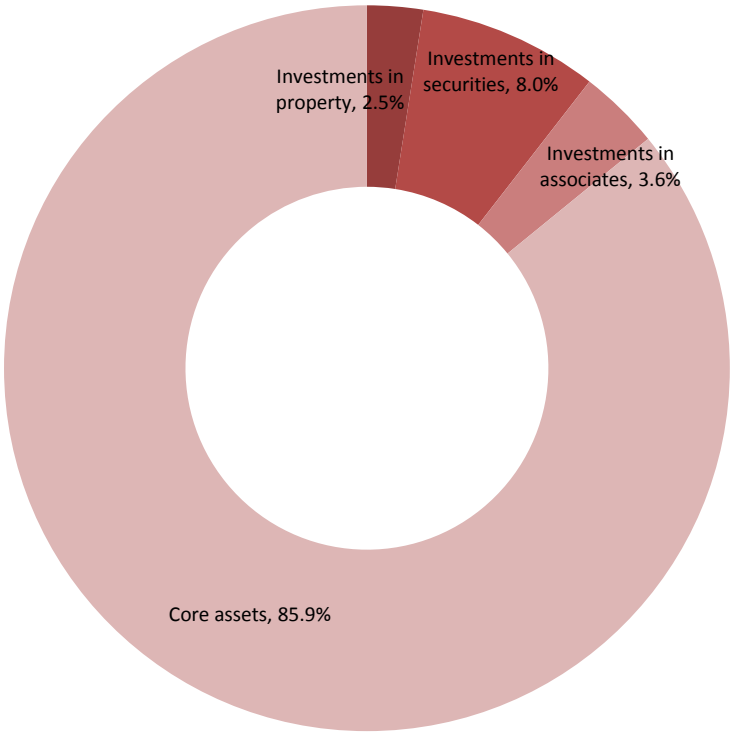
In short, companies with material investments in associates, securities and real estate may have a more uncertain outlook and this may disincline investors taking equity stakes. Chart 8 below represents a consolidation of all the assets of nonfinancial companies, showing that non-core assets accounted for 14 percent of total assets of nonfinancial companies at the end of 2015.

The final salient feature of Table 2 above is the last column which shows the average level of free float in each sub-sector. All sub-sectors have an average below 50 percent; in 2 cases, consumer goods and health care the average is below 25 percent, an internationally recognized minimum below which companies are generally prohibited from listing on the main bourse. The average across all nonfinancial companies is 38.1 percent; including nonbank financials and banks (i.e. all Kuwaiti listed companies) the average rises to 44.8 percent, significantly below 63.3 percent, the average for all emerging markets.[9]

Such low levels of free float, rather like balance sheets with large non-core investments, act as a disincentive to investors. The lower the free float the more difficult it is for an institutional investor to build a meaningful position. Moreover, shareholders need to have a clear understanding of who is controlling the business and that they have a voice in company

decisions. Low free floats could imply control by groups whose incentives are not necessarily aligned with institutional shareholders.

Chart 8: Noncore assets of nonfinancial companies



Sources: Bayanati, company financial statements

Section 2.2: Nonbank financial listed companies (excluding the insurance sector)

While many financial service companies have investments in real estate and many real estate companies have investments in securities, we have categorized each company in the sector which corresponds to its main focus, as reported on its respective balance sheet. As a result, according to our analysis[10], at the end of 2015, the nonbank financial sector of Boursa Kuwait was made up of 44 financial service companies and 41 real estate companies.

To summarize our findings, both financial service and real estate companies reported low profitability in 2015 and, like the rest of listed Kuwait, devote material amounts of their

resources to non-core assets. Both sectors also exhibit low free float levels: the average free float of financial service companies is 52.4 percent, and of real estate companies is 49.6 percent.

- **Financial services companies**

Excluding Commercial Facilities Company and Kuwait Projects Company, which are both lenders, the remaining 42 companies invest in securities, real estate and associates (which are, in many cases, investment houses). In effect, this sector, which accounts for 23 percent of all Kuwaiti listed companies, offers investors the opportunity to invest in the Kuwaiti fund management industry. It is unusual for a stock market to be so heavily weighted towards the investment sector. Generally speaking investors in a stock market (especially foreign investors) will look to invest their own money rather than buy shares in companies that invest money on their behalf.

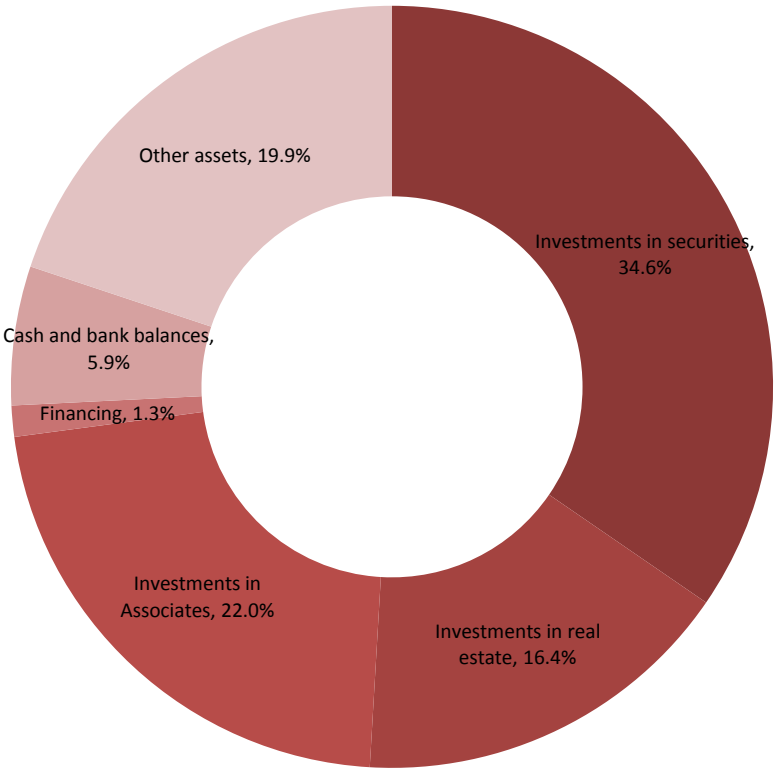
Chart 9 below represents a consolidation of all the assets of financial service companies, excluding the two above mentioned lenders.

A large fund management sector raises concerns for regulators charged with monitoring systemic risk, as indirect investing, via a listed corporate entity, potentially introduces leverage into an investment portfolio. In Kuwait, this is the case: the consolidated debt to equity of financial service companies (excluding the two lenders mentioned above) is 100 percent; for every KD of investment funded by shareholders, another KD is provided by creditors.

In a context in which profitability has fallen to zero, (in 2015, excluding the two mentioned lenders, ROA was 0.02 percent and ROE was 0.04 percent) it is little wonder that investor interest (as measured by turnover – see Chart 5) in this sector has collapsed. Indeed, this sector has been suffering from a vicious cycle in which poor stock market performance leads to deterioration in the value of their domestic portfolio leading to poor earnings and poor stock market performance.

Increases in oil prices and improved global sentiment, coupled with signs of easing regional and global tensions could all prompt renewed interest from investors; which would, as explained, be doubly positive for a 100 percent leveraged financial services sector. All the same, short term gains would do little to resolve the underlying systemic concerns that arise from having such a large listed investment sector. As things stand, it is reasonable to assume that this sector does not represent a growth area, either for corporate lending or the development of debt capital markets.

Chart 9: Financial services, consolidated balance sheet, year-end 2015



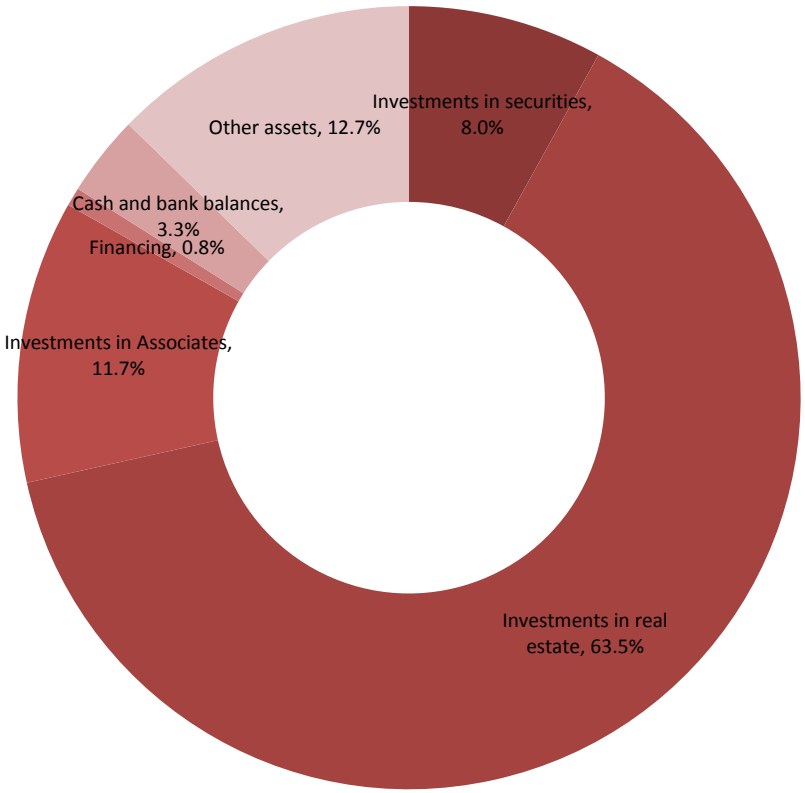
Source: company accounts

- **Real estate companies**

In total, at the end of 2015, there were 41 listed companies predominantly engaged in real estate. As with other industries Kuwaiti real estate companies reported lower profitability than emerging market peers. In 2015, the aggregate return on equity of the sector in Kuwait was 4.1 percent; the average of 1,190 developers, general and operational/service real estate companies in the emerging markets was 9.2 percent.[11] The return on assets of the aggregate Kuwaiti sector was 2.2 percent.

Like other Kuwaiti corporates, real estate companies also have large non-core business-related assets. As Chart 10 shows, investments in real estate, whether trading or long-term made up 63.5 percent of total assets at the end of 2015. Investments in securities made up 8.0 percent, investments in associates 11.7 percent.

Chart 10: Real estate companies, consolidated balance sheet, year-end 2015



Source: company accounts

Again, like other sectors, investments in securities creates volatility and unpredictability for investors looking to evaluate management's ability with their core business. On the face of it, the impact of investments in securities is fairly small, in aggregate net investment losses only reduced net income by 4 percent in 2015. However, this figure hides greater volatility at the individual company level. Of the 41 listed real estate companies, net profit was affected by over 25 percent (both positively and negatively) in 14 of them.

SECTION 3: FUNDING STRUCTURE

While there are structural issues inhibiting the development of capital markets in Kuwait; equally important is the demand for borrowing. Without the need for funding and credit, there is little incentive to develop more active capital markets or for banks to innovate and compete in process of matching borrowers to lenders.

Table 3 shows that since 2009, corporate credit growth has been significantly slower than consumer and personal loan growth. Lending to nonbank financial institutions has actually fallen, while lending for the purchase of securities has effectively stalled.

Table 3: Loan growth has largely come from the household sector

Loan type	2009 KD millions	2015 KD millions	Compound annual growth rate
Trade	2,260.7	3,114.8	5.5%
Industry	1,500.9	2,035.8	5.2%
Construction	1,786.7	1,953.3	1.5%
Nonbank financial institutions	2,903.7	1,342.4	-12.1%
Real Estate	6,597.3	8,048.8	3.4%
Personal consumer loans	629.7	1,195.2	11.3%
Personal Installment Loans	4,565.5	9,339.4	12.7%
Purchase of Securities	2,826.6	3,115.4	1.6%
Other	2,036.8	3,190.1	7.8%

Source: Central Bank of Kuwait

A proper assessment of the outlook for credit growth in Kuwait would require a detailed analysis of the economy, which we are not providing here. Instead, we ask two important structural questions. How leveraged are Kuwaiti listed companies presently; and what funding needs are being driven by capital expenditure?

While this study has primarily focused on capital markets, in this section we do not comment on whether that funding should be provided directly by banks of by capital markets (both debt and equity).

Section 3.1: Leverage

Table 4 below shows leverage by sector at the of 2015 for all listed Kuwaiti companies. Of most importance is the debt-to-equity ratio in the final column. The table shows, for instance, that in aggregate the health care sector had the highest leverage, with a debt-to-equity ratio of 177.6 percent. The basic materials sector had the lowest ratio, of 44.7 percent. In aggregate, listed corporate Kuwait had a debt-to-equity ratio of 84.0 percent. This means that for every 1 KD of

equity, there was 84 cents of debt. Put another way, at the end of 2015, 46 percent of total assets were funded by debt, 54 by shareholders (paid-in capital plus reserves).

While there is nothing that is necessarily alarming about this figure, leverage is higher among Kuwaiti companies than other emerging market listed equities. Debt-to-equity of emerging market equities is 46 percent, much less than Kuwait's 84 percent; 32 percent of assets being funded by debt, rather than 46 percent.[12]

Given these findings, it is reasonable to conclude that domestic sources of funding have been comprehensively utilized by Kuwaiti corporates. It may be that some companies will see an advantage in issuing bonds in the future to replace direct loans from the banks; but generally speaking, given current levels of leverage, the banking community is unlikely to see large increases in demand for borrowing coming from their corporate clients.

Table 4: Not a huge amount of room for more borrowings, KD millions

	Debt capital market borrowings	Short term bank borrowings	Long-term bank borrowings	Short term to total bank borrowings	Other liabilities	Borrowings as a percent of total liabilities	Debt to equity
Basic materials	0	18.1	145.4	11.1%	151.2	52.0%	44.7%
Consumer goods	0	89.7	16.1	84.7%	329.9	24.3%	73.2%
Consumer services	0	4.5	2.7	62.9%	11.5	38.6%	51.5%
Health care	0	93.4	10.8	89.7%	105.7	49.6%	177.6%
Industrials	0	13.7	369.4	3.6%	136.7	73.7%	146.1%
Oil and gas	0	30.4	71.2	29.9%	46.3	68.7%	78.8%
Technology	0	8.1	2.6	75.8%	21.5	33.2%	50.9%
Communications	0	319.2	909.7	26.0%	1626.8	43.0%	119.7%
Real estate	81.1	445.1	1146.3	28.0%	763.2	68.7%	82.8%
Financial services	25.5	1057.5	753.7	58.4%	876.6	67.7%	65.6%
Total	106.6	2079.7	3427.8	37.8%	4069.4	58.0%	84.0%

Source: Company financial statements

Note: Financial services does not include Kuwait Projects Company or the Commercial Facilities Group

In addition to illustrating leverage ratios, Table 4 also provides information on the make-up of liabilities. In aggregate, borrowings represent 58 percent of total liabilities; which suggests that working capital funding and borrowing from related parties form a significant part of Kuwaiti corporate finance. Other liabilities also include provisions for indemnity payments to employees upon leaving the company.

Finally, the table shows the degree to which borrowings are focused on one-year term facilities: in total 37.8 percent of total bank borrowings were due within one year at the end of 2015; with huge differences noted between the sectors. Such a high level of reliance on short-term borrowings could be a concern to creditors and financial supervisors.

While there is no indication of stress in the Kuwaiti economy and the banks remain well capitalized and provisioned, a heavy reliance on short term funding raises the risks that any future credit crunch, however unlikely, would be severe, as the banks could opt to reduce their exposures quickly by not rolling over one-year loans. And while the banks might argue that short-term facilities enable them to better match their assets and liabilities; generally speaking asset-liability mismatch risk is better mitigated by ensuring sufficient reserves and liquid securities.

Section 3.2: Real investment activity

Planned investment in plant and machinery, buildings and other fixed assets (including intangibles) is a key source of new demand for borrowing. A healthily growing corporate loan book is, first and foremost, predicated on increasing investment in real, as opposed to financial, assets.

Table 5 below shows, by sector, two key ratios commonly used to assess the levels of capital expenditure: capex to depreciation and net capex to sales. The first ratio provides a sense of whether the corporate sector is increasing its fixed assets; a ratio greater than one, for instance, implies that additions to fixed assets outweigh the 'using-up' (depreciation) of assets currently employed in the business. Net capex (capex less depreciation charges) to sales indicates what percentage of sales is being used to expand the fixed asset base of the company. Both ratios are helpful in comparing levels of capex across companies, industries and countries.

Table 5 excludes financial services in which investment is focused on the purchase of financial assets.

Table 5: Capital expenditure

	Capex/depreciation	Net capex/ sales	Asset turnover
Basic materials	86.8%	-0.7%	0.2x
Consumer goods	128.5%	1.2%	1.2x
Consumer services	216.3%	4.6%	0.5x
Health care	78.5%	-1.0%	0.8x
Industrials	196.6%	26.0%	0.1x
Oil and gas	152.8%	9.3%	0.3x
Technology	52.5%	-0.8%	0.9x
Telecommunications	133.7%	6.2%	0.4x
Real estate	772.7%	38.4%	0.1x
Total	165.3%	7.8%	0.3x

Sources: company financial statements, Boursa Kuwait

Overall, consolidated listed corporate Kuwait (excluding banks, financial services and insurers) has a capex to depreciation ratio of 165.3 percent. As one would expect, the ratio is much higher among more capital intensive industries than others – real estate has by far the highest

ratio. Looking at the consolidated ratio, we can conclude that Kuwaiti corporates are adding to their capital base.

However, the capex to depreciation ratio looks low when judged by international standards. The consolidated ratio for all sectors in emerging markets is 371.5 percent, more than double the ratio in Kuwait. Globally it is 245.0 percent; still significantly higher than Kuwait.[13]

On the face of it, the net capex to sales ratio paints a brighter picture; listed Kuwait's 7.8 percent is higher than the emerging market score of 6.4 percent and global 6.3 percent. All the same, given Kuwait's low capex to depreciation percentages, Kuwait's relatively high net capex to sales score may reflect on the denominator in the equation: i.e. that a higher proportion of sales is taken up investing in fixed assets than would otherwise need to be, all other things being equal, because assets are used relatively inefficiently. While asset turnover (sales divided by assets) varies dramatically across sectors, the fact that only one sector (consumer goods) reported an asset turn in 2015 greater than one (with most considerably below), suggests that Kuwait's net capex to sales ratio reflects inefficiencies rather than relatively high levels of capex.

Generally speaking, relatively low levels of capex in 2015 provide supporting data for why the commercial banks have focused in recent years on growing their consumer and personal loan books. All the while investment plans remain muted, corporate banking departments will most likely remain focused on rolling over facilities and competing among themselves for clients.

Were the economy to grow strongly and investment sentiment to recover, then there would be ample opportunities for Kuwait's financial sector. Traditional corporate banking departments would clearly gain. At the same time, given the suitability of bond financing for many investment projects, significant investment banking opportunities, especially in debt capital markets, could arise.

CONCLUSION: Preparing for future opportunities

The originating purpose of this study was to assess the attractiveness of Kuwait's capital markets to both domestic and foreign investors, thereby highlighting opportunities for the Kuwaiti banking community to further develop investment banking operations to complement their current focus on commercial banking. In the process of researching and writing this study, it became evident that the original research aim presupposed a level of capital market development not currently apparent in Kuwait.

As Section 1 demonstrated, not only is there no functioning debt market in Kuwait, but the stock market has been in a multi-year bear market, marked not just by a declining index but by significantly reduced turnover. Interest in investing in corporate Kuwait has markedly declined.

In Section 2, some of the reasons for the declining interest in capital markets were discussed. One reason is low profitability. While this no doubt reflects the economic cycle, there are also likely structural factors in play. For instance, listed Kuwaiti companies, more often than not, dedicate too many assets to non-core activities, while at the same time offering little transparency on who is actually controlling the company (reflected in low free float percentages). In this context, it appears unlikely that foreign investors will find the 'Kuwait' investment story' attractive.

Finally, in Section 3, it was suggested that the demand for credit from potential borrowers or bond issuers was limited by corporate balance sheets which are already fully leveraged and a lack of interest in fixed capital formation. The latter issue may predominantly be a cyclical problem. All the same, historically inefficient use of assets (low asset turnover) may undermine confidence in the ability of Kuwaiti corporates to issue bonds to fund multi-year investment projects.

While many of this study's conclusions can be read negatively, it is very important to appreciate the opportunities that exist for the Kuwaiti banking sector. Slow corporate loan growth and low levels of capex over the past few years may suggest increased capex and demand for borrowing in the coming years. Banks could start working with their clients now to explore future potential funding options, both commercial and investment banking based.

At the same time, each bank's corporate advisory department could offer to work with their corporate customers to discuss the structure of their balance sheets, suggesting ways to re-focus on core activities, thereby reducing leverage in advance of any future need to raise finance to fund real investment activity. In short, Kuwaiti banks should be investing now in developing expertise in all aspects of corporate advisory, corporate banking and debt capital markets to position themselves and their clients for a future upturn.

ENDNOTES

[1] *Vision of His Highness the Amir*, http://www.da.gov.kw/eng/festival/vision_his_highness.php
[2] World Bank Development Indices: Stock Markets, http://wdi.worldbank.org/table/5.4#
[3] Reuters, Kuwait requires secondary debt market – bank exec, September 27, 2016, http://in.reuters.com/article/kuwait-debt-idIND5N1A401T
[4] Central Bank of Kuwait, *Quarterly Statistical Releases*, Table 17: Local Banks : Balances of Utilized Cash Credit Facilities in KD to Residents & Non-Residents, by Interest Rate, http://www.cbk.gov.kw/en/statistics-and-publication/statistical-releases/quarterly.jsp
[5] Sources: Bloomberg, Bayanati, Boursa Kuwait
[6] Damodaran online, http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html
[7] An appropriate theoretical price-to-book ratio can be derived from the following formula:

$$Price\ to\ book = \frac{ROE - growth\ of\ dividends}{Cost\ of\ equity - growth\ of\ dividends}$$

[8] Damodaran online, http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html
[9] Ibid.
[10] Our totals are slightly different from Boursa Kuwait's categorization. This is due to our own assessment that some 'parallel' companies are essentially real estate or financial service companies and that some real estate companies are better understood as financial service companies; and visa versa.
[11] Damodaran online, http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html
[12] Ibid.
[13] Ibid.

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