Kuwait Investment Industry

Report Contents

Analysts

Dr Amani Bouresli
amani@capstandards.com
+965 22258822 ext.501

Kishore Karthikeyan
k.karthikeyan@capstandards.com
+965 22258822 ext.513

Sareh Rotabi
s.rotabi@capstandards.com
+965 22258822 ext.518

Capital Standards (CSR)

Al Nassar Tower, 11th Floor,
Fahad Al-Salem St., Kuwait City
P.O.Box 26620, Safat, 13127 Kuwait
Office: +965 2225 8822
Email: services@capstandards.com
Website: www.capstandards.com

Summary

Industry Performance

Investment companies (ICs) in Kuwait have lost approximately KWD 9.2 bn since the beginning of the financial crisis till the end of January 2009. The sector also registered cumulative losses of KWD 670.6 mn since the beginning of Q1 2009 to the end of Q3 2009. The primary reason of the slump was the heavy loss of the companies' portfolios in Kuwait Stock Exchange, which witnessed a 45.5% drop from KWD 16.7 bn to KWD 9.1 bn. The companies' stakes in foreign markets also registered a drop of 19% KWD 2.1 bn to KWD 1.7 bn.

Kuwait's investment sector has 101 companies as of September 2009, out of which 46 are conventional and 55 are Islamic investment firms. All these companies are regulated and monitored by the Central Bank of Kuwait.

Regional Review

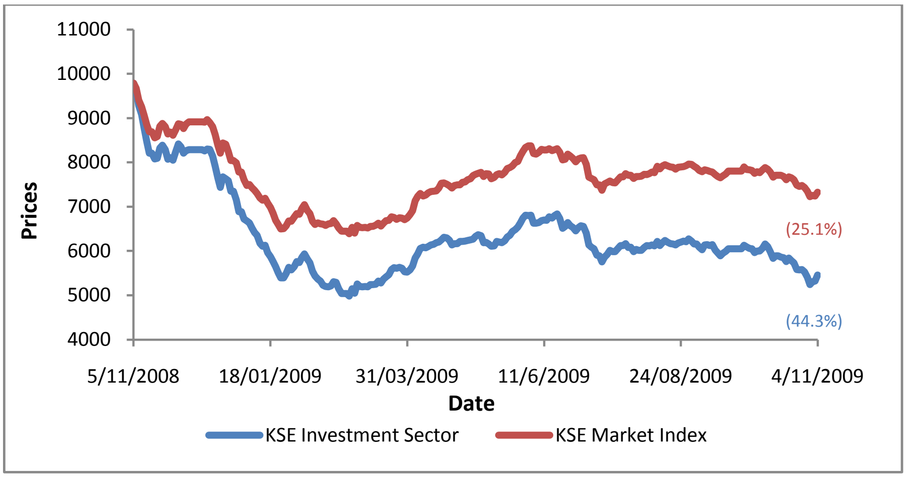
Despite the financial crisis and fall of oil prices, 2009's GDP is expected to reach USD 856.34 bn, which may sustain the GCC's economy. The IMF's 2009 forecasted economic growth for the GCC is 6.60%, a reduction from 2008's growth of 7.10%. According to the Securities & Investment Company in Bahrain, the nominal GDP of the GCC region is expected to fall by 20% in 2009 while the current account surplus is expected to fall to USD 50 bn from a level of USD 250 bn during 2008.

In the GCC region, some of the best performing mutual funds suffered a decline in 'Assets under Management' of up to 90% as the GCC stocks lost nearly two-thirds of their value. The fees from 'Asset Management' are also expected to fall as per Securities & Investment Company, Bahrain (SICO) and there is also a possibility for consolidations within the industry as managers seek economies of scale. There is a strong growth potential for the asset management industry in the region with an estimated USD 2.4 tn of funds largely untapped. A significant portion of these funds are invested in offshore markets and could flow back to the GCC. However, the underdeveloped capital markets and their lack of proper regulations in the region might impede the growth of asset management business.

National Review

It is evident from figure 1 that the Kuwaiti Investment Sector has suffered more than the overall Kuwaiti Market during the past year. This is due to the lack of faith that the investors have in their earnings and weak transparency policies followed by some of the companies operating in the sector. The losses sustained by the investment sector in Kuwait resulted in aggregate corporate earnings declining by 50% for the year contributing to a 25% decline in aggregate GCC corporate earnings.

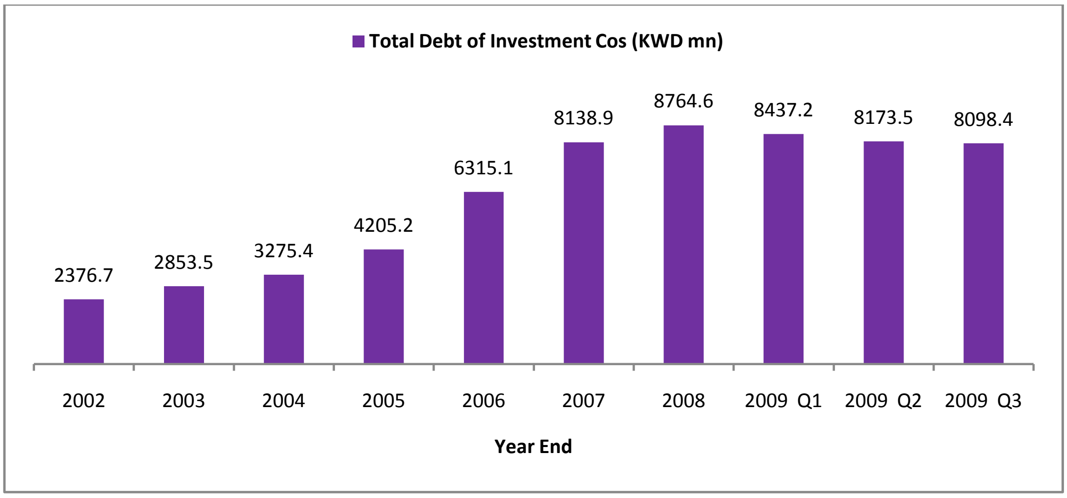
Figure 1: KSE Investment Sector Index vs. KSE Market Index



Industry Concerns

High leverage position

Figure2: Total debt of investment companies (Values are in KWD mn)

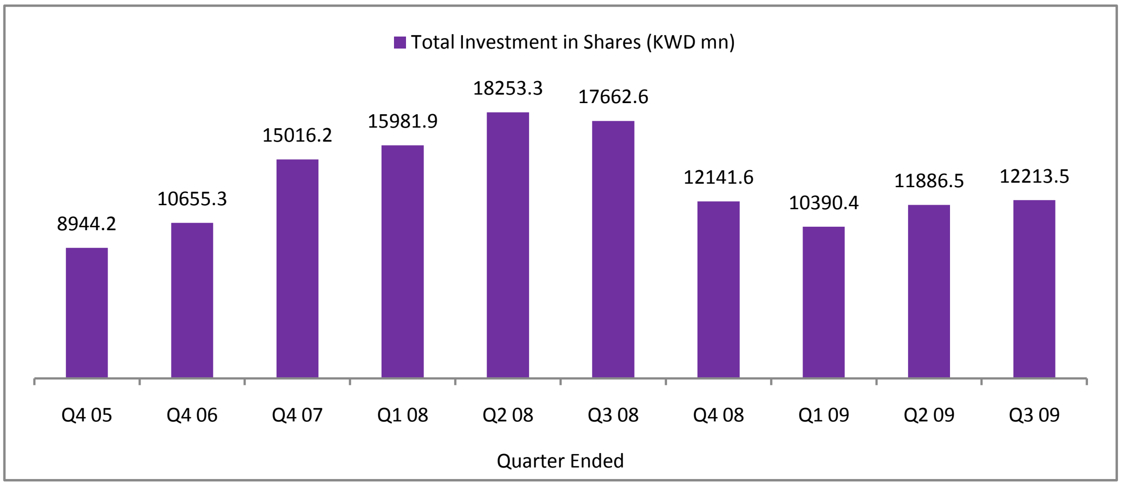


Source: Central Bank

The large increase in leveraged investment activity was the main reason for the imbalance in the investment sector. Figure 2 demonstrates that investment companies' debt has increased dramatically over the past seven years. This trend, however, has been declining after the losses in 2008, when companies had to liquidate a large portion of their portfolio of investments in order to cover their financial position. The asset breakout for 2007 and 2008 for these companies also shows that a significant decline in equity values as well. Another major issue was that the investment companies were relying heavily on new issuances of debt and equity in order to pay dividends and to meet their interest charges.

The effect on the investment sector was severe, which began with a decrease in the value of quoted investment by 40% and that of unquoted investments by 5%, with a total loss of KWD 892 mn in 2008. The investment sector proved to be highly leveraged during 2008. The sector's debt to equity ratio has increased from 0.98 x during 2007 to 1.48 x in 2008 as the companies simultaneously increased borrowing and suffered losses from investments. The sector requires a large amount of additional equity of more than KWD 2 bn in order to bring the ratio to 1.00x. The total debt for the investment sector decreased from KWD 12,607 mn in 2007 to KWD 11,858.9 mn in 2008 which accounted for a decrease of 6.3%.The total assets also decreased by 7.3%, from KWD 16,468.3 mn at the beginning of Q1 2009 to KWD 15,348.6 mn in Q3 2009, with stockholders equity decreasing by another 3%, from KWD 5795.4mn to KWD 5621.5 mn.

Figure 3: Kuwait Investment Sector's total investment in shares(Values are in KWD mn)



Investing in low liquid assets

Figure 3 demonstrates that investment companies had lost considerably on their equity value over the last year. These companies often invested in minority shares of private companies which further tightened their liquidity position. The IPO market, which has stalled out, aggravated the problem as investor's interest evaporated. Portfolios as a result tended to be primarily invested in funds and real estate ventures, of which many of the latter were delayed or cancelled.

The financial crisis further weakened the liquidity position of the companies. Since the majority of investment companies' assets are equities, the value of their shareholdings declined significantly, leading to an increase in default risk.

Investing through short term finance

Investment Companies were highly engaged in investing in long term assets through short-term financing. As a result, as liquidity sources declined, many financial institutions refused to roll over these short-term placements, forcing many of these investment companies to liquidate their holdings at a discount in order to meet their obligations or default.

The latest information from CBK shows that the total uncollected loans offered by banks to "non-banking financial institutions" amounted to KWD 2.9 bn at the end of September 2009, which represents 11.77% of the KWD 24.77 bn loans of the Kuwaiti banks. We believe that the loans to investment companies increased at a rate of three to four times during the past four years. This increase occurred during a period of favorable market conditions. According to a report issued by Standard Chartered, "about 70% of debt of investment is short-term to finance long-term assets". In addition, more than 40% of investment firms have a current ratio of 1 and a cash ratio of 0.1 (excluding marketable securities), which again demonstrates the precarious liquidity position of the investment companies.

According to official statistics, the assets of the investment companies doubled to KWD 18 bn or an equivalent of USD 66 bn since the end of 2006 until mid of 2008. It is estimated that about 40% of total debt of the investment companies was funded by foreign banks while KWD 2.80 bn was funded by local banks. An International Monetary Fund report on investment companies confirms that bank loans to local investment companies (12% of the total loan portfolios) suffered in quality. The deterioration in the liquidity of investment companies directly affected the quality of the assets of banks and indirectly created pressure on the stock prices of those banks.

Key Industry Trends

The losses incurred during 2008 were primarily the result of overinvestment in illiquid assets (such as private equity, real estate, etc) and the fall in the world equity markets, which caused contractions in quoted investments and funds.

The Kuwaiti Investment Sector proved to be highly leveraged in 2008. According to the Arab Times, the investment sector had an average debt/equity ratio of 0.94 in 2007, which climbed to 1.48 in 2008 as companies took on more debt and their equity declined as a result of investment losses. Assuming that liabilities remain constant in 2009, equity is expected to contract to about KWD 3 bn while assets are expected to decrease by KWD 8 bn as they continue to deteriorate in value or are liquidated to cover maturing debt.

Losses incurred by the investment companies in the years 2008 & 2009 demonstrate that the current business model employed by the sector is highly volatile and unsustainable over the long-term. The recent crisis shall more than likely force companies to alter their business models.

The government assistance of KWD 1.5 bn to the sector, in the form of stimulus packages, credit lines, equity injections, etc., has indicated some support from the government. As a response to the financial crisis, the "Financial Stability Law", which was passed in late March 2009, guaranteed 50% of the existing and new debt provided or yet to be provided to investment companies. If current distressed asset values recover and appreciate in the future, then investment companies are in a position to benefit significantly. However, the strong government support will come in the form of more mega infrastructure projects initiation and hence, more financial policies are activated by the government.

Group Performance Review

Data as of Q3 2009	Kuwait Projects Co.	Global Investment House	National Investment Co.	The Securities House	Kuwait Investment Co.	Al Safat Investment Co.
Key Ratios						
PE Ratio	9.3	NEG	NEG	NEG	10.2	NEG
Payout Ratio	191.43	NIL	NIL	NIL	NIL	NIL
Cash Operations / Revenue	0.14	(0.01)	(263.48)	0.80	0.59	10.4
Return on Assets	1.19	(14.15)	(2.58)	(11.39)	2.22	(4.57)
Return on Equity	10.99	(67.17)	(3.13)	(49.11)	4.94	(7.21)
Total Debt/Equity	280.61	291.22	17.14	NIL	54.72	55.3
Asset Growth	(2.83)	(36.16)	(31.43)	(18.13)	(15.42)	(36.38)
Key Figures (KWD mn)						
Current Market Cap (mn)	565.74	133.86	315.43	103.36	68.25	89.66
Cash & Cash Eq.	805.77	89.57	(18.14)	16.71	(77.50)	0.93
Net Income	45.61	(104.16)	(5.06)	(23.76)	5.02	(6.74)
Net Change in Cash Position	(117.56)	33.91	23.51	(22.13)	20.91	(12.02)

Source: Zawya

When we look at the actual company data of some major players in the investment sector, it reflects similar issues faced by the whole sector in general. Most companies have registered net losses during YTD 2009. The PE ratio is negative (NEG) except for Kuwait Projects Co. (KIPCO) and Kuwait Investment Co. (KIC). This is attributed to KIPCO's larger size and the higher confidence of the investors in its financial strength. KIPCO is among the very few companies that have registered profits during the period primarily due to its asset quality which comprises mainly of banks and entertainment companies.

Global Investment House (GIH) is the worst performer among its peers as the value of its investments eroded during the crisis. The assets of the company were mainly concentrated in countries abroad which were heavily affected by the unstable conditions of the global economic crisis. Most investment companies in Kuwait have registered a negative return on both equity and assets during Q3 2009.

The average total debt/equity of these companies is high due to leveraged investment activities. This is evident in the case of KIPCO and GIH. All firms have registered a negative growth in their assets during Q3 2009. The Cash & Cash Equivalents position of the investment companies also shows that the companies either have a negative cash position or a negative change in their cash position during Q3 2009.

What were the key causes?

The financial crisis led most investment firms facing potential debt default, as many were highly dependent on short term financing to fund their long term investment activities. The heavy reliance on long-term real estate investments caused a liquidity crunch for these companies during the financial crisis since their investments could not be liquidated at satisfactory values. Their investment portfolios also included a significant amount of unquoted investments which were illiquid.

What actions happened after this event?

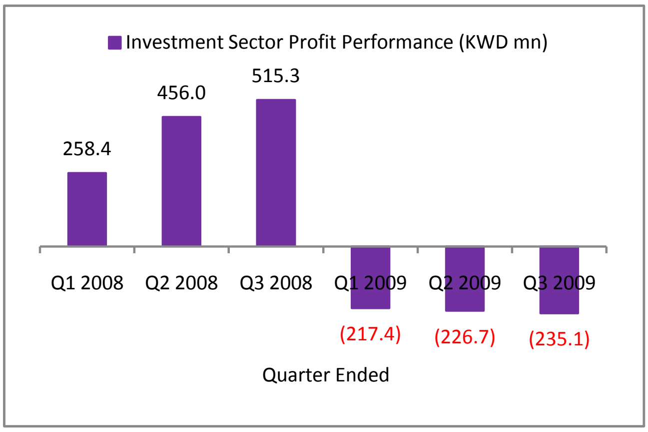
Government actions

As the financial crisis worsened and the risk of economic instability increased, the Kuwaiti government initiated actions such as passing a new financial stimulus law with the aim of stabilizing the financial sector, sustaining local economic activity, and stimulating additional bank financing to the local market. The law, which was adopted under a necessity decree, is intended to inject additional liquidity and its executive procedures issued on 2nd April 2009. However, many investment companies did not apply to the financing program, which required meeting certain minimum solvency and higher disclosure requirements.

Sector performance

The latest 2009 update shows that the investment sector suffered losses of KWD 226.5 mn, in the third quarter of 2009. In a similar way, the total losses incurred during the first two quarters of 2009 were KWD 444.1 mn. Accounting practices such as IAS 39 helped minimize realized losses, however, further losses are anticipated. This is especially true for some of the major players in the investment sector such as Global Investment House, the Investment Dar, and some other smaller companies. These companies face continued challenges to their survival.

Figure 4: Investment Sector Profit Performance



Some investment companies have made early steps to a return to stability, while there continues to be a major risk of future default and bankruptcy. Positive signs are appearing as companies succeed in restructuring their debt and merging with their peers (GIH). Gulf Investment House and First Investment Company, for instance, are evaluating their assets and are in the process of merging. From a credit standpoint, we believe that investment companies will rate their bank loans in order to clarify their exposures to their lenders and to facilitate their restructuring.

Outlook & Key Drivers

Investment companies are likely to perform better in 2009 than 2008, considering they had incurred a net loss in 2008 of KWD 892 mn due to the impairment in the fair value of assets. The losses incurred during 2008 were primarily the result of investments in illiquid assets, such as private equity, real estate etc. and also due to fall in the world equity markets which had caused contractions in quoted investments and funds.

The Key Drivers for the growth would be as follows:

The Oil Prices – The Oil Price is the major factor that determines the activities in the region. We believe that as oil prices begin to recover, the region is also expected to rebound.

Stimulus Package – The Economic Stimulus package that has been proposed by the government is also expected to provide support to these investment companies who are considered the main drivers of growth in the GCC countries.

Competition – The competition from private equity firms and government holding companies is a key factor. As market penetration by private equity firms and funds increases, the traditional investment holding companies will have less opportunities in which to invest. As the Kuwaiti economy is limited, local investment companies will have to concentrate on nearby regions for investment opportunities.

Limited Investments Opportunities – The scarcity in lands available for investment, limited government capital expenditures, the domination of government on the public sector, the scarcity of infrastructure projects, and the limited access to investment opportunities decreased the competiveness and the potential for this sector to recover or to attain higher grow rates.

Proper Legal Structure – a unified new securities law is needed to better organize and regulate the investment companies' activities, since some of the current laws and provisions that govern their activities need to be updated and reviewed to be more flexible.

Dividend Policy – Investment companies will have to ease their dividend payouts as this has been one of the factors that have hindered their liquidity position.

Portfolio Selection – The investment companies will need to focus on investments that can create long term value, stable dividends during the short term, and provide easy exit during the long term.

Governance & Risk Management Practices – Better governance and risk management practices are required within the sector. This is a key driver as the lack of governance and risk management practices can directly lead to weaker portfolio selections and imbalances in asset liability management. .

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