From Frontier to Emerging: What's an Upgrade Worth?

By Jane Williams, Editor Knowledge Arabia

Regulators and investors in the rich Gulf states of the United Arab Emirates (U.A.E.) and Qatar are celebrating the recent Morgan Stanley Capital International (MSCI) upgrade of their countries from frontier to emerging market status. But how important are these rating revisions, and what do they really mean for the countries involved?

The MSCI is the most widely used equity index provider in the world tracking around US$7.3 trillion of equities. For young nations like the U.A.E. and Qatar - who measure their development by their international ratings and rankings - a rise from frontier to emerging market status is a big step towards being recognised as modern, contributing economies able to provide the technology and safe, transparent systems and processes necessary to attract sophisticated foreign investors.

Sultan Bin Saeed Al Mansouri, the U.A.E. Minister of Economy and chairman of the country's capital markets regulator, describes the decision as a "giant stride forward". "This… will give greater depth to the market in the medium to long-term, giving it more power and boosting its competitive status at the international level," he told journalists after the announcement.

How much impact the MSCI revisions will have on the region's stock markets is another matter.

"I have not seen evidence to suggest that an upgrade in the MSCI global equity index accurately tracks improvements in the underlying economic fundamentals," notes **Stephen Mezias**, INSEAD Professor of Entrepreneurship and Family Enterprise, at the Abu Dhabi Campus.

"According to a pure cash flow theory, the MSCI certification should make no difference."

An upgrade, says Mezias, may bring in more institutional investors – those with emerging but not frontier market portfolios - and attract independent investors who enter the market on the belief others will, creating a herd dynamic.

"While this may re-invigorate lack lustre trading in the short-term, the question is for how long?"

Attribution problem

Michael Prahl, Centre Director for INSEAD's Global Private Equity Initiative, says it's questionable whether any market action can be directly ascribed to an index status.

"Overall there is always an attribution problem as to how far changes observed after an upgrade are connected to the upgrade or whether its due to the underlying economic factors that drove the upgrade in the first place," he notes. "While some people or institutions will rely on ratings agencies (and sometimes have statutory requirements to do so) and change their investing behaviour accordingly, many others will look through for the fundamentals."

When it comes to private equity investment, which is very much a micro game, index revisions such as the recent MSCI review, have very little direct affect. The upgrades can, however, have a net benefit on the overall economy (as witnessed in Indonesia recently) which might have a spill-over effect on private equity (PE) in the long run.

“Index funds can allocate more to the local stock markets increasing liquidity and therefore [long-term] provide more options for exiting PE backed companies,” Prahl says. “Similarly, in debt markets, more liquidity and lower cost of debt can make borrowing for PE firms easier. In emerging markets, however, leverage, typically, is used sparsely and therefore the impact is likely muted.”

From the investor side, institutions might find it marginally easier to allocate to PE funds operating in those countries. Although, in the case of the U.A.E. and Qatar, political unrest across the broader Middle East is currently obscuring this benefit.

Emerging markets party

The Gulf nations will also be hampered by a cooling of the two-year love affair between investors and emerging economies.

The day after the MSCI revisions were announced the Emerging Markets Index dropped two percent to a nine-month low. The index is down 10 percent for the year and 20 percent since June 2011.

“Investor sentiment is beginning to turn away from emerging markets, hampered as they are by slowing growth rates and weakening currencies,” agrees **Vinika Rao,** Executive Director of the INSEAD Emerging Markets Institute, noting emerging nations are being increasingly overlooked as the greenback rallies; rumours of fiscal tightening abound; and U.S. treasuries begin to look safer.

“[For Qatar and the U.A.E.], inclusion in the Emerging Markets Index alongside heavyweights like China, India and Brazil, will undoubtedly have a continuing positive impact on global inflows and price performance… as foreign institutional investors, especially the passive/tracker funds linked to the index, react to the news. On the flipside, the Abu Dhabi, Dubai and Qatari markets have likely already factored in the upgrade to a large extent.”

Milestone development

Regardless of the impact, the U.A.E. and Qatar, remain optimistic. With good reason. Emerging markets indices may be on the slide but the Dubai Financial Market General Index has soared 45.3 percent so far this year, just as the Abu Dhabi Securities Exchange General Index gained 35.5 percent, putting them among the five top performing stock exchanges in the world. And Eisa Kazim, managing director and CEO of the Dubai Financial Market (DFM) can't keep the smile off his face. "The re-ignited interest of local and foreign investors towards the Dubai Financial Market (DFM) since the beginning of the year underlines that what we have implemented caters to investors' expectations and the attractiveness of the U.A.E. markets to foreign investments."

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