



EQUITY RESEARCH

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Please refer to the last page for important disclaimer

# Saudi midcaps

## Identifying the stars of tomorrow

- **Recent introduction of the free float (FF) methodology has reduced the concentration of Saudi markets:** Large cap\* (LC) companies earlier dominated the TASI index comprising 60.8% of the aggregate market. Under the new free float methodology, midcap\* (MC) stocks overtake large cap with a free float weight of 47% (versus 46.3% for large cap).
- **Focus on identifying the 'boys' of today who will be the 'men' of tomorrow:** Portfolios of many KSA mutual funds have traditionally been dominated by LC companies in an attempt to avoid tracking errors (top 10 companies comprise 63.4% of aggregate market cap). The changes in market structure increase the importance of identifying mid-cap stars who are the 'boys' of today who will be the 'men' of tomorrow. Table 2 (page 11) highlights 11 such companies who have seen significant growth in the last three years. An equal weighted portfolio of these companies would have generated a return of approximately 300% over a 3-year horizon (versus TASI returns of 36%)
- **Playing the midcap story – focus on fundamentals is key:** Investors can build exposures to the segment by identifying selective opportunities in the MC space or through a professionally managed vehicle such as a midcap fund. Identifying the right investment opportunities based on underlying fundamentals is critical to identifying the winners of tomorrow. As an example, in appendix 1 we highlight 16 MC companies who passed four filters – liquidity (average daily traded value in excess of \$ 1 mn), valuation (historical price to earnings ratio less than 20 and price to book ratio less than 5) and profitability (return on equity for 2007 in excess of 15%)
- **Healthy historical performance & attractive valuations:** In general midcap stocks exhibited steady growth during recent years. Even during the downturn of 2006, midcap stocks did not fall as much as large cap stocks
- **Many mid-caps start-off as IPOs:** Many of the IPOs during the past five years classify within the midcap space. These have outperformed the market (and small cap companies) since going public
- **Case study - banking:** The banking sector has witnessed tremendous growth during 2003-07, wherein many midcap banks have transformed into large cap banks. Similar success stories exist in other sectors such as industrials and telecom
- **Investment opinion:** Careful stock picking within the midcap space, especially within the sectors such as industrials and banking will, lead to potentially higher returns in the next three to five years

\*We define large cap (LC) as companies with a market cap more than SAR 50 billion. Midcap (MC) is defined as companies with market cap between SAR 3 bn and SAR 50 bn.

Figure 1: Classification of companies

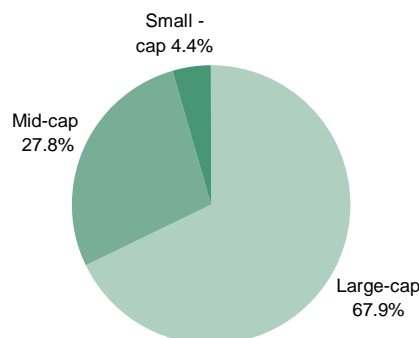
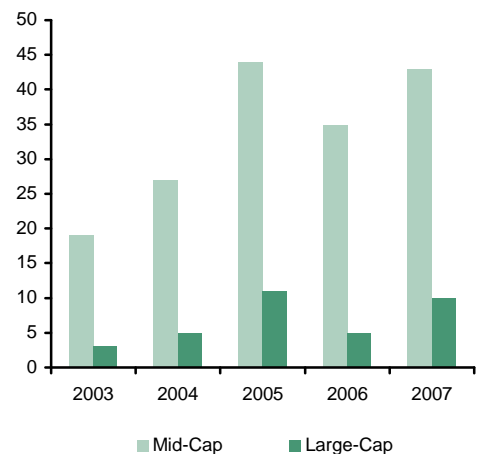


Figure 2: Number of companies



Source: NCBC Research , Tadawul Stock Exchange  
(As on 31-12-2007)

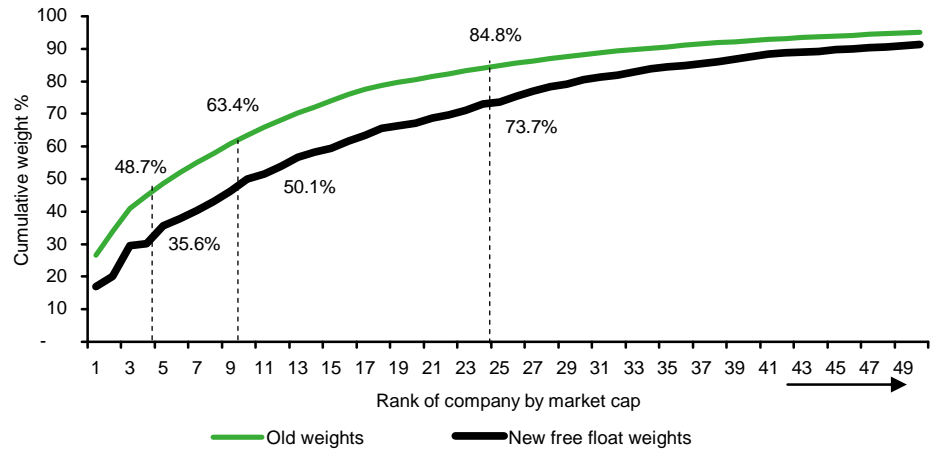
Source: NCBC Research

## Reduced concentration of large cap companies in Saudi

The recent change to a free float methodology will lead to a decrease in the concentration of companies in Saudi markets (see our research note titled "Tadawul - Structural Changes" dated Apr 08, 2008). The earlier index had over 48.7% of the market concentrated in the top five companies. The revised free float index has just 35.6% of its aggregate value derived from the top five companies.

Concentration of companies drop significantly with top 5 companies comprising 35.6% of aggregate market (from 48.7% earlier)

**Figure 3: Concentration ratio of large caps companies drop significantly**



Source: NCBC Research , Reuters

Interestingly, the top 10 companies in the revised index will have almost the same weight as the top five in the existing index. This has important implications from the perspective that the broader market will be driven more by the movements of a larger cross section of companies and become more representative of broader sentiment.

## Midcap segment grew 23% between 2003-07

- Saudi Arabia's aggregate market cap grew by 35% between 2003-07 to reach SAR 1.95 trillion (\$520 billion)
- LC stocks grew by 43.6% to reach SAR 1.32 trillion during the same period while MC stocks increased by 22.8% to reach SAR 540.5 bn by market cap
- Of the 111 companies listed on the Tadawul Stock Exchange at the end of 2007, 43 were MC (39% of the total number of listed companies) while 10 were LC stocks (mostly in the banking sector). Small cap (SC) stocks at 58 represented the majority of listed companies
- The MC segment increased by 8 companies over 2006 while in 2005 the steep valuations of the Saudi markets pushed a number of SC companies into the MC definition

43 of the 111 listed companies in Saudi Arabia were MC companies at the end of 2007

## Market cap and volume contribution of midcaps

- Midcaps historically dominated volumes and market cap. The landscape has changed in 2007 as several new IPOs (driven by the insurance sector) have added a number of new companies to small caps
- Most banks which were classified as large cap in 2007 started off as midcap back in 2004

Most banks, which were classified as large cap in 2007, started as midcap back in 2004

Figure 4: Break-up by number of companies in each segment

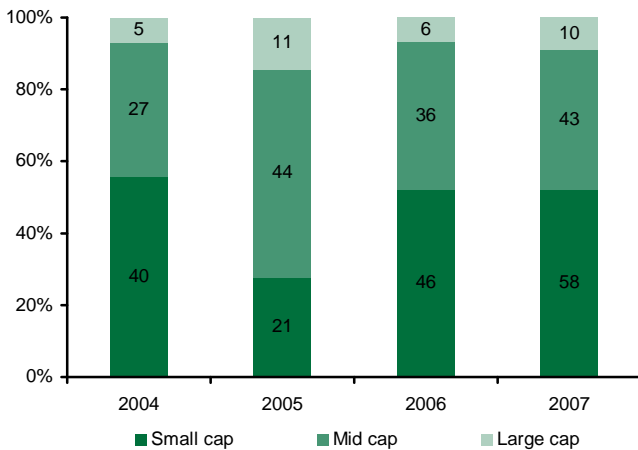
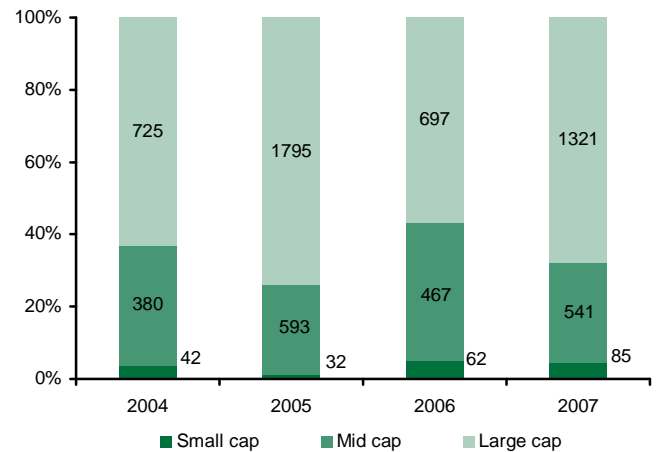


Figure 5: Break-up by market cap (SAR bn)



Source: NCBC Research  
 Note: Figures above represent actual numbers of companies while the bar represents share of aggregate market cap

Source: NCBC Research  
 Note: Figures above represent actual market cap in SAR mn while the bar represents share of aggregate market cap

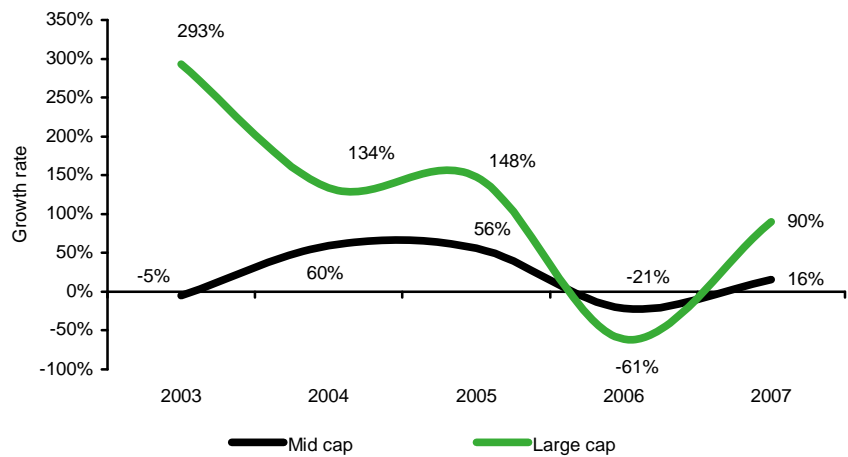
Though their performance has been less spectacular, MC stocks collectively have grown steadily

On a hand picked portfolio, MCs would have generated 300% returns versus 82% (LC) and 36% (TASI)

### Stable market cap over the years

- For the category as a whole, midcap stocks have lagged behind large cap stocks in terms of market cap growth. Though their performance has been less spectacular, midcap stocks have grown steadily. In contrast large cap stocks performed worse than midcaps during the corrections of 2006
- We should point out however, that astute investors who were able to spot the opportunities early on would have generated a return of 300% over a three year period ending 2007 had they invested in the basket of 11 stocks highlighted in table 2 (page 11). In contrast the universe in figure 6 would have seen a cumulative gain of 82% for all large caps, 42% by all mid-caps and 36% for the TASI index

Figure 6: Market cap growth (%)



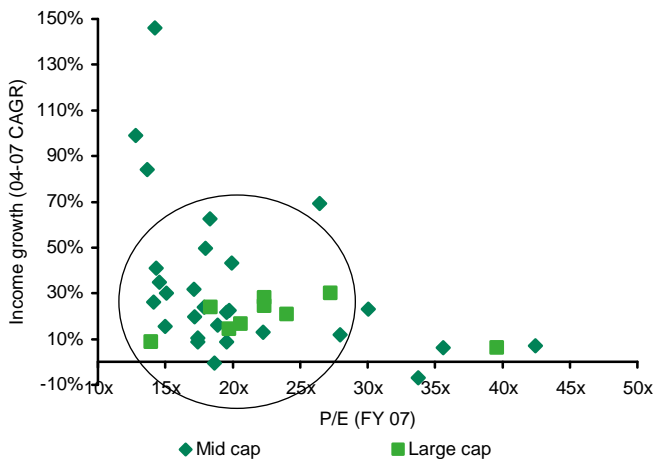
Source: NCBC Research

### Selective midcap stocks provide better value

On the basis of P/E ratios versus growth selective MC provide compelling investment case

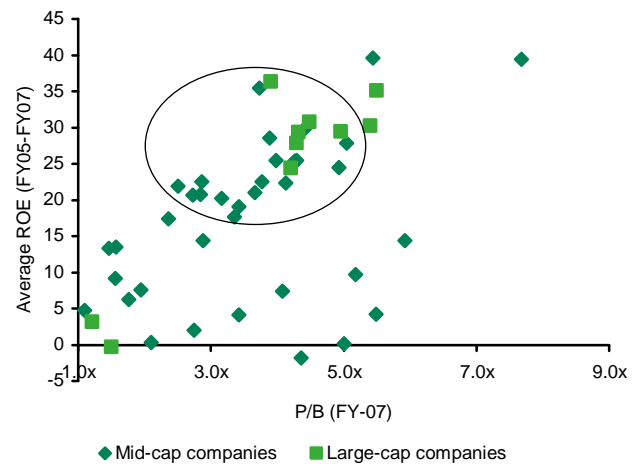
- On the basis of price to earnings ratios versus earnings growth, selective midcaps provide compelling investment case
- Several midcaps have profitability profiles similar to large caps but at lower price to book valuations

Figure 7: Break-up by number of companies in each segment



Source: NCBC Research

Figure 8: Break-up by market cap (SAR bn)



Source: NCBC Research

## 2007 has been an aberration for mid caps

- MC stocks collectively have averaged a dividend yield of 1.7% against 3.6% for LC
- Return on assets for MC companies at 3.8% lag LC at 7.1%
- Note that for the universe in table 2 (page 11) the average ROA is 12.9% (sharply higher than that for LC)

Figure 9: Dividend yield

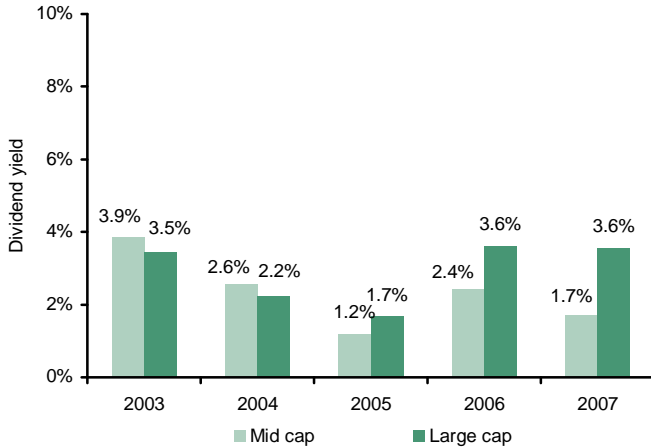
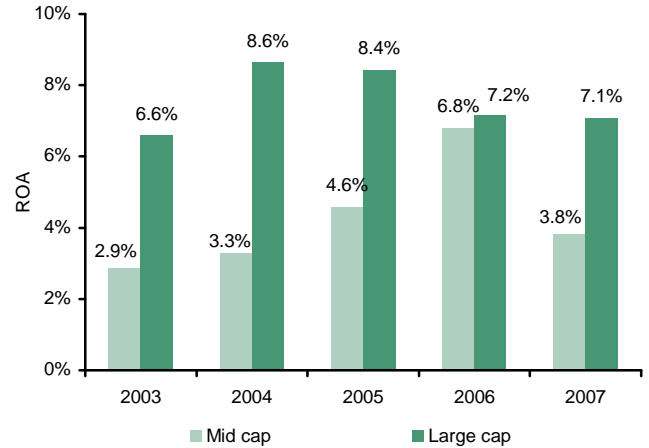


Figure 10: Return on assets



Source: NCBC Research

Source: NCBC Research

## Successful mid caps have displayed resilience

- Successful MC companies have shown consistent earnings growth
- In the years where MC companies' earnings dropped, successful MC grew
- Successful MC companies have higher ROE than other MC companies and fared as well (if not higher) than LC

Figure 11: Earnings growth

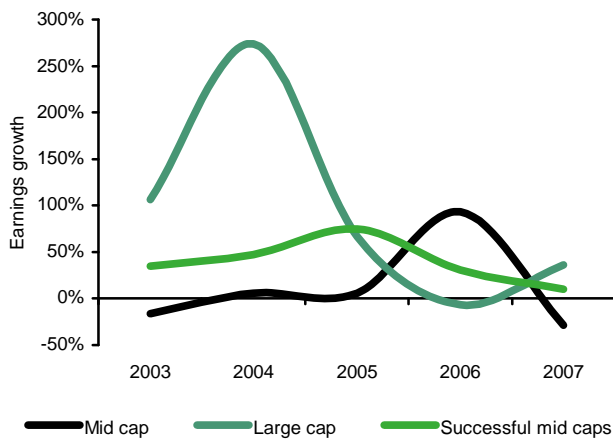
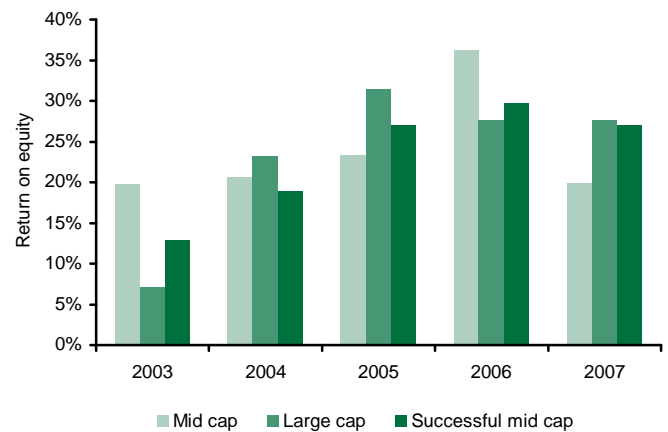


Figure 12: Return on equity



Source: NCBC Research

Source: NCBC Research

## Most listings are in the industrial sector

- MC have a high concentration of industrial and services sector companies
- LC have a large concentration of banking stocks

Figure 13: Sector-wise breakup of midcap companies

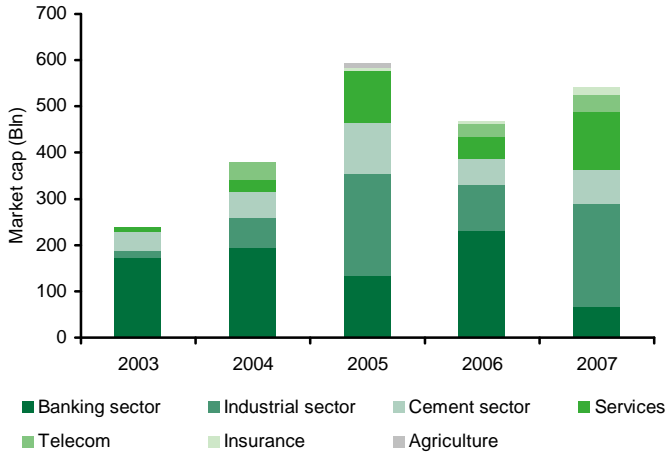
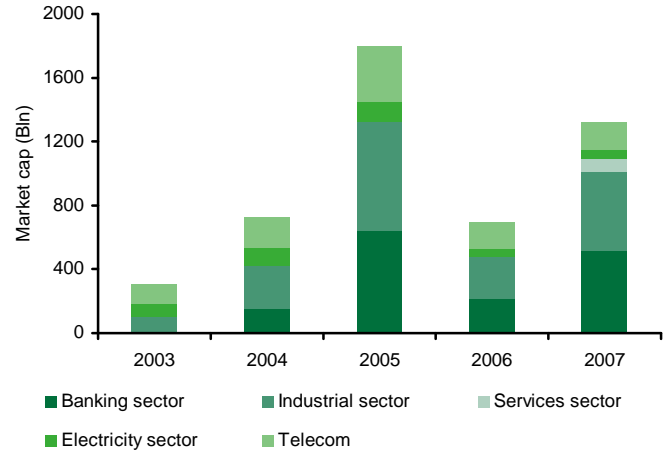


Figure 14: Sector-wise breakup of large-cap companies



Source: NCBC Research

Source: NCBC Research

## IPOs: Profile of midcap issuances

Excluding the insurance sector almost 50% of IPOs since 2003 fall under the midcap space

- There were a total of 46 IPOs during 2003 to March'08, out of which 14 companies qualify as midcap companies
- Due to regulatory changes in the sector most of the IPOs since 2007 have been in the insurance sector, all of which were in the small cap space. If we exclude all such IPOs (total of 17 since 2007), almost 50% of the IPOs fall under the midcap space
- In terms of market capitalization at the time of listing, midcap companies had a 65% share of the total IPOs

Figure 15: Break-up of IPOs in value terms (SAR bn)

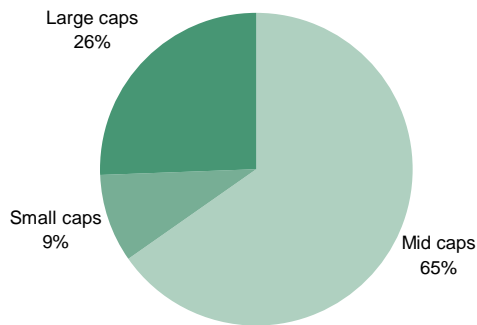
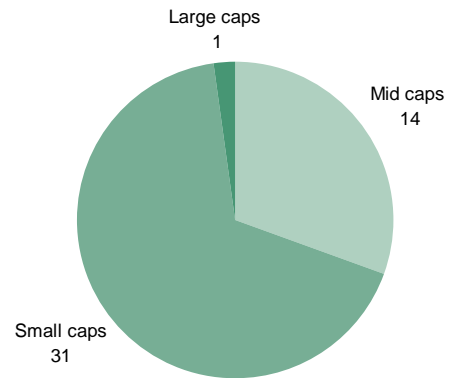


Figure 16: Break-up of IPOs in volume terms



Source: NCBC Research  
 Note: The above IPO data is for the period Jan 2003 till Mar 2008 on the Tadawul Stock Exchange

Source: NCBC Research  
 Note: The above IPO data is for the period Jan 2003 till Mar 2008 on the Tadawul Stock Exchange

## Midcap IPOs are attractive investment opportunities

**Table 1: Annualized sector returns of IPOs from flotation till 2007**

	Small cap	Mid cap	Large cap	Total
Banking	NA	113%	NA	113%
Industrial	86%	173%	NA	141%
Insurance	1552%	987%	NA	1270%
Services	30%	40%	NA	36%
Telecom	NA	210%	80%	145%

Source: NCBC Research

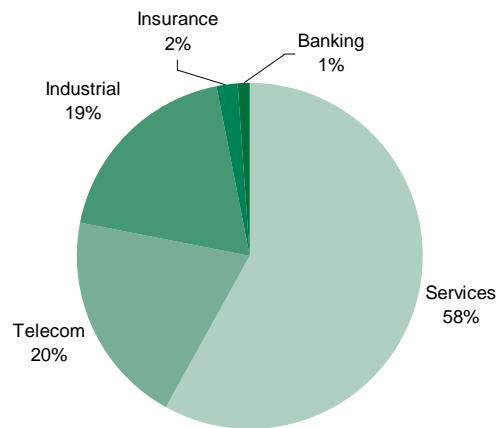
Note: The above analysis excludes all such IPOs which listed during the last six months of 2007

In the above table the companies have been classified as small, mid or large cap based on the market cap as on Dec 31, 2007 (not as of the time of IPO)

**Across sectors, MC exhibited better annualized gains since their flotation**

- Across sectors, midcap companies exhibited better performance on the basis of annualized returns of market capitalization since their flotation
- The annualized returns of small cap insurance stocks is higher than that of midcap insurance stocks, mainly due to the reason that all except one insurance IPO came after the Saudi market started recovering from the 2006 correction

**Figure 17: Sector break-up of IPOs in value terms**



Source: NCBC Research

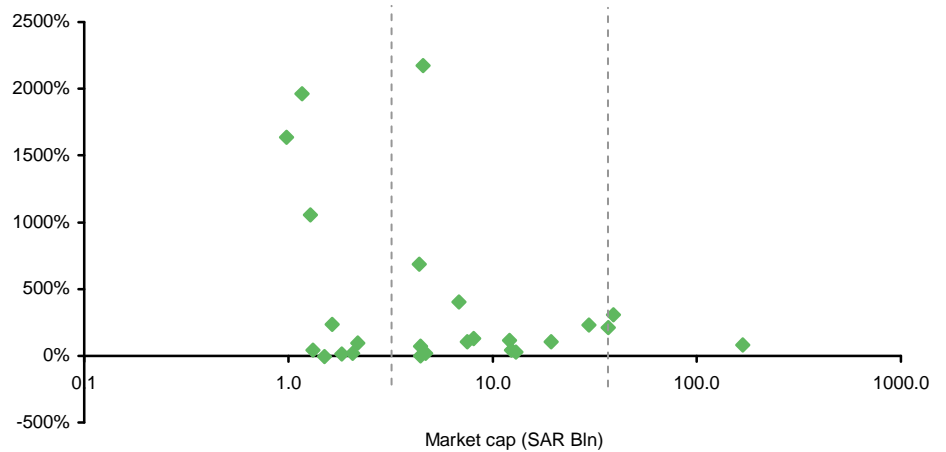
Note: The above analysis is for all the IPOs listed on Tadawul Stock Exchange for the period Jan 2003 till Mar 2008

Midcap IPOs have consistently generated superior returns over small and large cap IPOs

## Distribution of performance of IPOs in KSA

- Figure 16 plots the IPO returns across listings with different market capitalizations
- Midcap IPOs have consistently generated superior returns over small and large cap IPOs
- Some of the small and midcap stocks have risen by more than 10 times from the listing price. All of the IPOs with 'multi-bagger' returns have been in the insurance sector in 2007 where regulations stipulated a listing as mandatory
- Other successful IPOs in the midcap space are:
  - Advanced Polypropylene Company (405%)
  - Saudi Kayan Petrochemical Company (306%)
  - Yanbu National Petrochemicals Company (230%)
  - Mobily (210%)
- IPOs issued within 180 days have been excluded as their annualized returns significantly distorted the results

**Figure 18: Distribution of annualized returns of IPOs (from flotation to 31-12-07)**



Source: NCBC Research

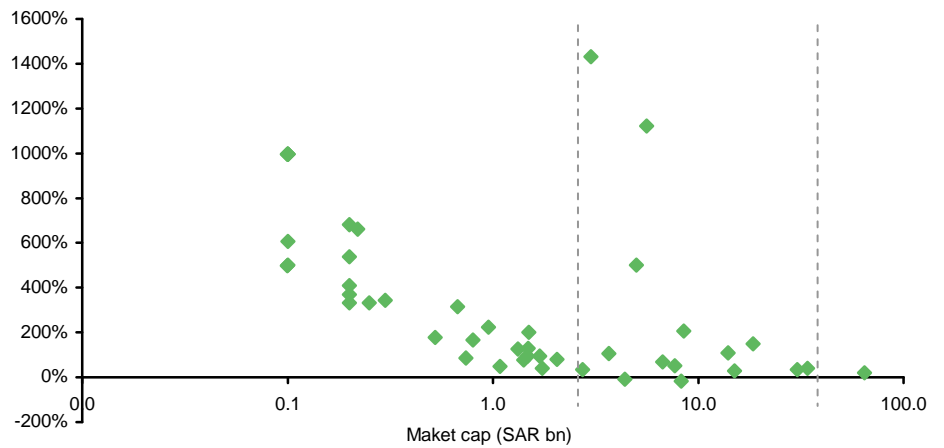
Note: Data between the grey lines represents the midcap universe  
Returns computed as of December 31, 2007 since their flotation

Exclude the insurance IPOs, average return of MC stocks on day of listing was 272%, more than double the 127% average of small cap IPOs

### IPO performance on listing and over the next 6 months

- Figure 17 indicates the gains on the day of listing of all IPOs since Jan 2003
- If we exclude the insurance sector IPOs, the average return of midcap stocks together on listing day was 272%, more than double the 127% of that of small cap IPOs
- The midcap IPOs provided significantly higher returns on the listing day when compared to large cap IPOs

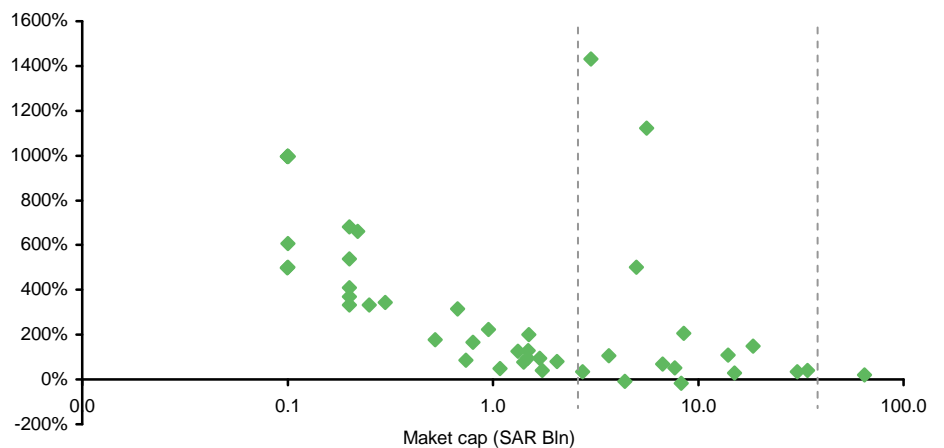
Figure 19: Return on day of listing



Source: NCBC Research  
 Note: Data between the grey lines represents the midcap universe  
 The above analysis is for all the IPOs listed on Tadawul Stock Exchange for the period Jan 2003 till Mar 2008

- Figure 18 indicates the change in market cap after six months from the date of listing
- Excluding insurance stocks, most midcap companies provided better or commensurate returns as that of small cap IPOs
- Additionally midcap IPOs also proved to be better performers vis-à-vis large cap listings

Figure 20: Return in 6 month from listing date



Source: NCBC Research  
 Note: Data between the grey lines represents the midcap universe  
 The above analysis is for all the IPOs listed on Tadawul Stock Exchange for the period Jan 2003 till Mar 2008

## Identifying successful midcap stocks

Some of the biggest success stories have emerged from the non-oil sectors such as banking and industrials

- Table 2 highlights some of the successful stocks that have grown from SC to MC companies as well as MC stocks that have grown significantly to move into the large cap space or rise rapidly the market cap ladder
- Some of the biggest success stories have emerged from the non-oil sectors such as banking and industrials. The increase in market capitalization has been backed by strong growth in net income of the successful stocks
- Tadawul All Share Index (TASI) rose 36% over the same period

**Table 2: Select mid-cap stock successes**

Company name	M.Cap SAR Mn		Rise in Mcap (2004-07)	Mcap then & now	ROE (%)		Net inc. CAGR (2004-07)	P/E 2007A
	Dec-04	Dec-07			2004	2007		
<b>Mid-cap successes</b>								
Bank AlJazira	2,997	14,738	391.7%	MC to MC	15.8	18.1	61.7%	15.9
Saudi Arabia Fertilizers Co.	9,940	39,700	299.4%	MC to MC	16.2	41.1	49.0%	19.4
Arab National Bank	14,220	55,055	287.2%	MC to LC	24.9	26.6	27.9%	16.5
Banque Saudi Fransi	18,495	65,109	252.0%	MC to LC	29.1	26.3	20.6%	17.7
Savola Group	5,596	17,906	220.0%	MC to MC	25.6	18.6	34.4%	17.7
Qassim Cement Co.	3,868	8,145	110.6%	MC to MC	22.8	38.4	29.6%	12.9
<b>Small cap successes</b>								
Saudi Cable Co	675	4,332	541.8%	SC to MC	4.6	34.5	143.8%	19.7
National Industrialization Co.	2,901	17,479	502.6%	SC to MC	15.3	11.5	68.5%	25.0
Taibah Investment & RE Co	1,399	5,363	283.4%	SC to MC	5.5	13.5	83.0%	11.3
Zamil Industrial	1,326	4,118	210.5%	SC to MC	15.1	25.3	42.8%	16.7
Jarir Marketing Co	1,841	4,725	156.7%	SC to MC	31.8	44.5	31.5%	16.9

Source: NCBC Research

## Transformation case: Banking sector

- Over a period of just four years, six companies transformed themselves into large cap banks
- Most of the midcap companies of 2003 have transformed into large cap in 2007
- There are no small cap banks in 2007

Figure 21: Number of companies - 2003

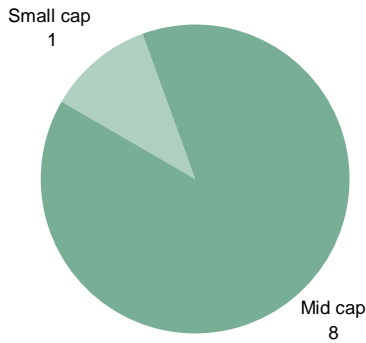
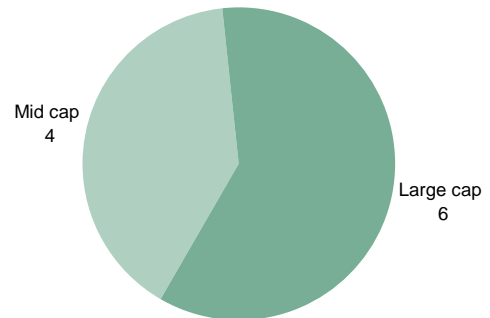


Figure 22: Number of companies - 2007



Source: NCBC Research

Source: NCBC Research

- The total market cap of the banking stocks increased more than four fold during 2003-07 to reach SAR 583 bn
- Large cap companies represented approximately 89% of total market cap at the end of 2007

Figure 23: Market cap (SAR bn) - 2003

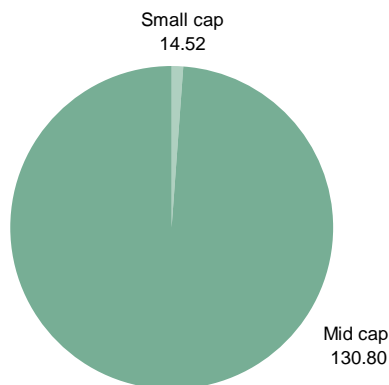
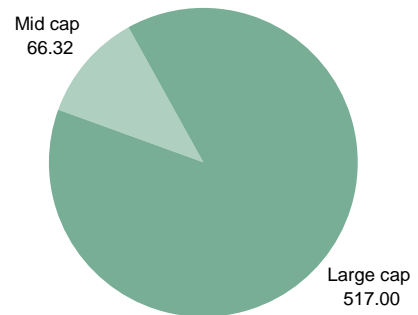


Figure 24: Market cap (SAR bn) - 2007



Source: NCBC Research

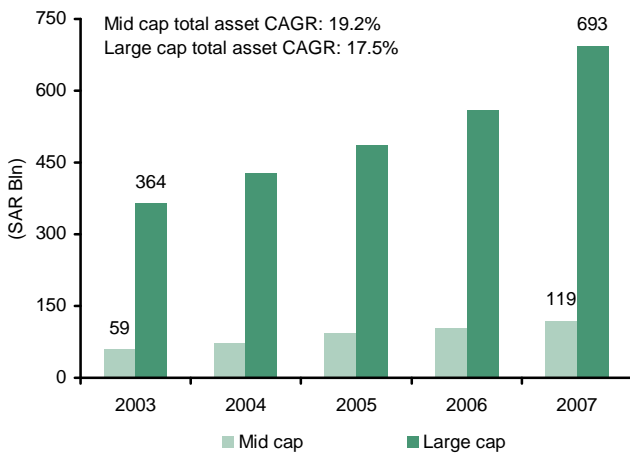
Source: NCBC Research

## Midcap banks witness strong growth

Earnings growth of MC banks during 2003-06 was a healthy 62.1% (vs. 42.5% for LC banks)

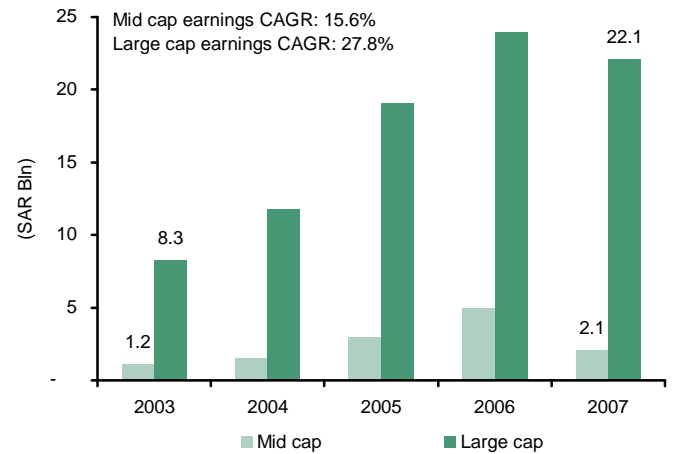
- During 2003-07, total assets of midcap banks grew at a CAGR of 19.2% (versus 17.5% of large cap banks)
- The earnings growth of midcap banks during 2003-06 was a healthy 62.1% (versus 42.5% for large cap banks)
- In 2007, a drastic decline in fee-based income led to a decline in earnings of midcap banks. Accordingly earnings of midcap banks grew at a CAGR of 15.6% during 2003-07 (versus 27.8 % for large cap banks)

Figure 25: Asset growth



Source: NCBC Research

Figure 26: Net income

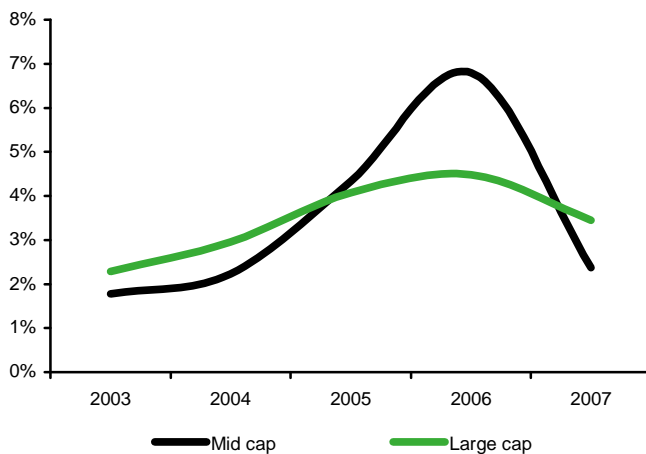


Source: NCBC Research

## Profitability & valuation of midcap banks

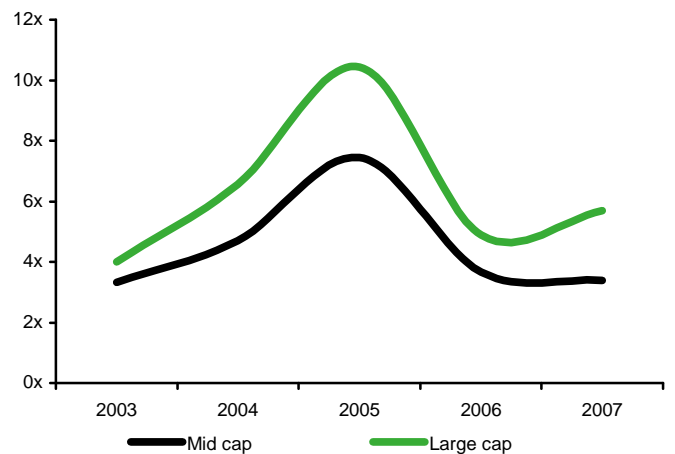
- Due to the size factor, midcap banks ROA declined rapidly in 2007 due to pressures on fee incomes. We expect that the market recovery will help them rebound in profitability
- Despite the higher growth potential midcap banks have historically traded at a lower P/B multiple to that of large cap banks

Figure 27: Return on assets



Source: NCBC Research

Figure 28: Price to book



Source: NCBC Research

## Appendix – Filtering Saudi midcap stocks

The list of 16 companies below is the result of a set of quantitative filters we applied to all listed Saudi companies:

1. **Midcap definition:** We analyzed companies who had a market cap between SAR 3 to SAR 50 bn
2. **Liquidity:** We used companies with an annual daily traded value of at least \$ 1 million
3. **Profitability:** We selected companies who had a return on equity in excess of 15% in 2007
4. **Valuation:**
  - Historical P/E: We short-listed companies whose price to earnings ratio based on the current price and earnings in 2007 was less than 15 times
  - Historical P/BV: We short-listed companies whose price to book value ratio based on the current price and share holders equity at the end of 2007 was less than 5 times

**Table 3: Select Saudi midcap companies with attractive fundamentals**

Company name	MCap SR mn	FF %	TASI Wt%	ADTV \$m	P/E 07A	P/BV 07A	ROE 07A	ROA 07A
NCCI	5,313	60	0.46	6.0	10.1	2.9	29.1	11.0
SRMG	3,760	66	0.36	3.2	10.3	2.7	28.2	18.5
Yanbu Cem	8,715	54	0.68	3.3	13.2	3.8	30.0	27.5
Savola	16,500	68	1.64	38.9	13.4	2.3	18.6	10.8
East Prov Cem	7,353	48	0.51	5.9	13.6	3.5	27.4	23.0
Yamamah Cement	10,733	90	1.41	11.1	14.7	4.5	32.2	21.8
ANB	37,050	49	2.65	3.6	15.1	3.5	26.6	2.9
Bk AlJazira	12,488	74	1.34	15.8	15.5	2.7	18.1	4.3
Tabuk Cem	3,555	96	0.50	6.3	16.1	3.4	21.0	17.5
Arabian Cem	6,500	74	0.70	3.6	16.6	3.5	22.5	19.1
SPCC	11,690	48	0.82	4.2	16.6	5.0	31.0	27.4
BSF	46,969	55	3.76	3.2	17.3	4.2	26.3	3.0
Dar Al Arkan RE	34,965	30	1.53	74.7	17.4	3.2	18.3	10.9
Saudi Cem	12,725	87	1.60	2.8	18.5	4.6	26.6	20.9
FA AlHokair	4,060	30	0.18	7.5	18.7	4.6	38.0	28.7
Zamil Indl	4,028	76	0.44	2.9	19.5	4.5	25.3	6.0

Source: NCBC Research

ADTV (Average daily traded value) based on daily average for Q1-08

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