A topsy-turvy May for GCC Markets

Kuwait All Share Index registers best yearly performance

June 2019

Research Highlights
GCC Economic and Market Commentary for May, 2019

www.markaz.com
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M.R. Raghu, CFA, FRM
Head of Research
+965 2224 8280
rmandagolathur@markaz.com

Shishir Goenka
Senior Manager - Research

Ajay Samuel
Senior Analyst

Arnav Singh
Analyst

Chirag Popat
Analyst

Kuwait Financial Centre K.P.S.C "Markaz"

P.O. Box 23444, Safat 13095, Kuwait
Tel: +965 2224 8000
Fax: +965 2242 5828

Kuwait registered the best yearly performance of 16.9% followed by Saudi Arabia at 8.8%. Kuwait market was resilient to the negative sentiment that prevailed in the regional and global equity markets. Kuwait's resilience is noteworthy in an otherwise choppy month where the pan GCC index fell by 5.6%. The S&P GCC composite index recording its worst monthly loss in over three years. Trade tensions between U.S.-China and regional geopolitical uncertainties resulted in investor sentiments turning sour despite the positive events in GCC's equity markets. The global story was no different as the positive start to 2019 for the U.S. and emerging markets came to a halt. Oil prices also witnessed a decline after registering substantial gains in previous months.

We see the following three issues as key developments during the month of May:

1. **Kuwait rolls out final phase of market development:** Continuing with its capital market reforms, Boursa Kuwait launched the third and final phase of its market development project. These reforms are initiated to standardize the capital market on par with global standards and gather attention of the international investors. The success story of market development in the past is evident from Kuwait's upgradation to the emerging markets status by FTSE Russell and S&P Dow Jones. MSCI meanwhile has also put Kuwait on its watch list for upgradation.

2. **How will trade war, Iran sanctions, OPEC supply cuts shape Oil markets in 2019:** EIA has forecasted a rise in oil spot prices in its Short Term Energy Outlook for the month of April. Average crude oil prices have trended upwards for four consecutive months in 2019 with risk factors like the end of waivers for US sanctions on Iranian crude exports, unrest in Venezuela and sustained production cuts from OPEC contributing to higher oil prices. The intensifying US-China trade war on the other hand has introduced demand concerns affecting market sentiments and acting as a ceiling to the oil prices.

3. **Operating Margins of Kuwaiti Stocks – Real Estate faces margin contraction:** We analyse how the profitability of companies in Kuwait have fared across different sectors over the years by comparing their operating margins. Real Estate and Telecom stocks have been witnessing a downtrend since 2013. Challenging operating conditions, sluggishness of the property market in the GCC region and the saturation of the mobile phone market are observed to be the driving factors for margin contraction in these sectors.

GCC Market Commentary

GCC Market Trends – May 2019

	M. Cap (USD Bn)	Last close	2018 %	May'19 %	YTD %	S&P correlation**	ADVT* (USD mn)	P/E TTM	P/B TTM	Div. Yield
S&P GCC	893.6	115	8.4	-5.6	7.1	0.110	N.A	14.8	2.0	3.4
KSA	535.4	8,516	8.3	-8.5	8.8	0.036	1,349.6	17.1	1.9	3.6
Abu Dhabi	143.6	5,004	11.7	-4.8	1.8	0.072	46.6	12.7	1.4	5.0
Qatar	137.3	10,273	20.8	-1.0	-0.3	0.092	102.9	13.7	1.4	4.2
Kuwait	105.5	6,606	7.8	2.1	16.9	0.029	92.3	13.9	1.4	3.4
Dubai	72.1	2,620	-24.9	-5.3	3.6	0.095	45.2	7.3	0.9	4.8
Bahrain	23.3	1,434	0.4	-0.0	7.2	0.050	2.0	10.3	0.9	5.1
Oman	12.3	3,934	-15.2	-0.3	-9.0	-0.009	2.9	8.9	0.7	6.6

Source: Reuters, Zawya, Note: * Average Daily Value Traded ** - 3-year daily return correlation with S&P 500 index

The S&P GCC composite index, a comprehensive benchmark that covers stocks from all GCC countries, lost 5.62% for the month due to regional geopolitical events and the inability of China and U.S. to reach agreement on a trade deal. Saudi Arabia and Dubai indices were the worst affected, losing 8.47% and 5.30% respectively in May. . Abu Dhabi, Qatar, Oman and Bahrain also ended the month on a negative note, losing 4.84%, 1.00%, 0.29% and 0.03% respectively. Kuwait was the lone gainer among GCC markets, registering a gain of 2.09% in May.

Monthly returns heat-map of S&P GCC Composite index

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yearly
2014	3.4%	3.7%	2.7%	2.8%	3.2%	-7.4%	8.1%	6.4%	-1.4%	-6.8%	-10.9%	-4.4%	-2.5%
2015	2.8%	4.4%	-6.9%	10.1%	-2.3%	-3.5%	0.1%	-13.2%	-1.1%	-2.7%	-2.3%	-2.4%	-17.4%
2016	-10.7%	3.7%	1.9%	5.7%	-5.1%	1.1%	-0.1%	-1.2%	-3.9%	2.2%	7.9%	4.2%	4.2%
2017	1.6%	-0.8%	-1.5%	-0.4%	-1.4%	3.2%	-0.4%	0.9%	-0.6%	-2.7%	-1.5%	3.4%	-0.5%
2018	5.3%	-2.5%	3.4%	2.9%	-0.4%	1.1%	2.2%	-2.5%	0.2%	0.1%	-2.0%	0.7%	8.4%
2019	6.8%	-1.0%	2.8%	4.4%	-5.6%								7.1%

Source: Reuters

Kuwait markets were resilient to the negative sentiment that prevailed in the regional and global equity markets, surpassing Saudi Arabia to become the best performing GCC market in YTD 2019. Positivity surrounding Kuwait's chances for an MSCI EM upgrade has helped its All Share index register positive returns for the month. Boursa Kuwait also rolled out the final phase of its market development plan, which is expected to introduce several improvements to the capital markets and present a strong case for Kuwait's MSCI EM inclusion. Zain Telecom and Boubyan Bank were the top gainers among Kuwait's Blue Chip stocks, increasing by 13.4% and 4.6% for the month. Zain's stock performance was an indication that investors were happy its Zain's Q1 2019 numbers, which was released during the month of May, where its net profit grew by 15% YoY.

Saudi Arabia's index, which traded at a premium to other GCC markets, fell sharply during the month due to the increasing geopolitical tensions triggered by the drone attack on Saudi oil vessels. Saudi Arabia's entry into the MSCI EM index partially offset the monthly losses, while its yearly gains were nearly halved by the end of the month. Regional tension spilled over to the UAE as well, with Abu Dhabi's index erasing its yearly gains.

Among GCC Blue Chip companies, Mesaieed Petrochemical Holding Company (MPHC) from Qatar was the top gainer, with its share price increasing by 32.7% in May. MSCI's decision to include three Qatari companies including MPHC into their indices triggered its rise, while the rest of Qatar's Blue Chip companies ended the month in the red. Woqod and Qatar Aluminium Manufacturing Company (Qamco) were the other two companies that made it to MSCI's list. A similar negative trend was noticed among Blue Chips in Saudi Arabia and the UAE, with DP World and First Bank of Abu Dhabi losing 14.5% and 7.1% for the month. Abu Dhabi Commercial Bank (ADCB) and Union Bank officially merged during the month, with the combined entity acquiring Al Hilal Bank to create UAE's third largest bank by total assets. ADCB lost 9.1% for the month, reducing its yearly gains to 10.0%.

Global Market Commentary

Global Market Trends – May 2019

Equity	Last close	MTD%	YTD%
S&P GCC	115	-5.6	7.1
Kuwait	6,471	2.1	16.9
MSCI World	2,046	-6.1	8.6
S&P 500	2,752	-6.6	9.8
MSCI EM	995	-7.5	3.3
MSCI FM	944	1.0	4.3
Commodities			
IPE Brent	64	-11.4	19.9
Gold	1,305	1.7	1.8

Source: Reuters

Global investors who were positive since the turn of the year, hoping for an amicable resolution to the ongoing trade war were in for a surprise, as the U.S. and China failed to resolve their differences and reach an agreement over a deal. The negative impact of this ongoing tit-for-tat tariff imposition on global economic growth has raised investor concerns worldwide. Consequently, global equity markets felt the effect, giving up a large portion of gains accumulated during the year. Among developed markets, the U.S. S&P 500, U.K.'s FTSE index and Japan's TOPIX fell by 6.6%, 3.5% and 6.5% respectively for the month. The Federal Reserve continued to delay moving the Fed rates either way, deciding to keep the rates unchanged after its monthly Federal Open Market Committee (FOMC) meeting. After witnessing a series of hikes in the past couple of years, investors now expect one or two rate cuts in 2019. Emerging markets were not spared from the equity onslaught, as the received a much harder hit compared to developed markets. The MSCI EM lost 7.8% for the year while China's Shanghai A Share Index lost 5.8%. Indian markets were the exception, with the SENSEX gaining 1.7%

during the month, as investors were happy with the outcome of the country's general election.

We see the following three issues as key developments during the month of May:

1. Kuwait rolls out final phase of market development

Continuing with its capital market reforms, Boursa Kuwait has launched the third and final phase of its market development project. Prior to this, it successfully completed Phase I in May 2017 and Phase II in April 2018. These reforms are initiated to standardize the capital market on par with global standards by introducing instruments such as (Short selling, Reits trading platform, swap service etc.) in the market and attract international investors. The success story of market development is evident from Kuwait's upgradation to emerging markets status by FTSE Russell and S&P Dow Jones. MSCI meanwhile has also put Kuwait on its watch list for upgradation.

Key market reforms

Parameter	Previous scenario	Present scenario	Date of implementation	Implication
Investor Registration & Account Set up	Arabic translation was required	Process simplified with English documents also accepted	May-2017	**Higher Accessibility, Time saving**
Clearing and Settlement	Absence of a real Delivery versus Payment (DvP) system as well as failed trades mechanism	DvP settlement provision was introduced with a buy-in board mechanism	Apr-2018	**Lower principal risk**
Custody	Unlimited access of trading accounts to local brokers. While local custodians lacked control over the securities	An improved false trade mechanism was introduced. Thereby, limiting broker's access to investors' custody accounts.	Apr-2018	**Greater security of assets**
Foreign Ownership	100% except for banks where the limit is restricted to 49%	Limit raised to 100% for banks. Foreign shareholding of >5% in banks will require prior approval of CBK	Dec-2018	**Higher liquidity**
Transferability	Manual in-kind transfers and off-exchange transactions[1]	Testing on automating the system has commenced. Settlement: T+3 cycle.	Active	**Cost saving, Efficiency**

Source: MSCI | T: Transaction date

The final phase of development entails changes such as, improving off-market trade, introduction of REITs trading platform and after-hours trading session. The

[1] In-kind transfers and off-exchange transactions are important tool for manager transitions, mergers of funds and in the creation and redemptions of ETF shares. However, manual process is time consuming and cumbersome.

financial instruments include a swap service, and a tender offer service that allows any person to acquire at least 5% and up to 30% of the shares of any listed company. The implementation of short selling, lending and borrowing of shares that are part of the final phase of market development will also be done after further testing. Short selling facilities will be available through approved brokers.

The stock exchange will also adjust its trading mechanism to a 10% circuit instead of 5% earlier. This means that whenever a stock reaches an upper or lower circuit of 10% it will automatically stop trading for next couple of minutes. The price at which 10% circuit was hit, will act as the reference price to determine the new level of 10% circuit post the two minute break.

The Boursa Kuwait will also launch a trading session after market close wherein stocks can be traded for 5 additional minutes at the closing price. After-hours trading could be useful to perform bulk deals, react to any new news/information and is much more convenient.

As evident from the table below, Kuwait capital market still lags behind its regional peers and developed markets in some of the market infrastructure parameters like stock lending, registry/depository, short selling etc. With the implementation of various measures through its phase wise market development process, Boursa Kuwait's market infrastructure will improve thus making it more standardized and competitive with stock markets in regional and developed countries.

Market assessment comparison

Market infrastructure	Kuwait	Saudi Arabia	UAE	Qatar	USA
Clearing and settlement	+	+	+	+	++
Custody	+	+	+	+	++
Registry / Depository	+	++	+	++	++
Trading	++	++	++	++	++
Transferability	-/?	-/?	+	-/?	++
Stock lending	-/?	-/?	-/?	+	++
Short selling	-/?	-/?	-/?	-/?	++
Competitive Landscape	++	+	++	++	++

Source: MSCI | Note: ++: no issues; +: no major issues/improvements possible; -/? : improvements needed

Boursa Kuwait will provide a platform for the trading of REITs that are Shariah compliant. Trading activities will be done through licensed brokers who are registered with Boursa Kuwait. Publicly trading of REITs on the platform will allow investors with small capital to invest in real estate. Further it would provide an alternative to those who want to avoid the burden of holding and managing a property by themselves. It will also be a source of regular income for investors as at least 90% of the net profits of REITs are required to be distributed as dividend periodically. This will be an attractive source of income since the annualized dividend yield for GCC listed Reits stood at an average of 7.5%, as compared to the annualized dividend yield for Kuwait stock exchange of 3.7%.

REITS structure comparison between Kuwait and Saudi Arabia

Parameter	REITS Structure in Kuwait	REITS Structure in Saudi Arabia
Asset Restrictions	Income generating properties in Kuwait only. (Investment in vacant lands, securities, development projects, funds, properties outside Kuwait is prohibited)	At least 75% of the fund's total assets value must be invested in income generating properties. Investment in vacant lands is prohibited.
Asset concentration	Investment on single property should not exceed 30% of Fund's NAV. REIT with single property allowed if property value exceeds KD 30mn	Investment in properties outside Saudi Arabia limited to 25% of fund's total assets.
Leverage Ratio	Up to 50% of fund's asset is permitted.	Up to 50% of fund's asset is permitted.
Distribution Requirement	Minimum 90% distribution of net profit annually. (Periodic distribution of Dividend is allowed)	Minimum 90% of the fund's net profits must be distributed annually
Listing Criteria	Minimum number of unit holders: 225 with KD 5,000 lot or 450 with KD 2,500 KD or 900 with KD 1,250 KD Minimum float value: KD 15mn	Minimum 50 investors Minimum float value: SAR 100n All REITS issued at nominal value per unit of SAR 10 At least 30% of the total REIT units are owned by unit holders from the public

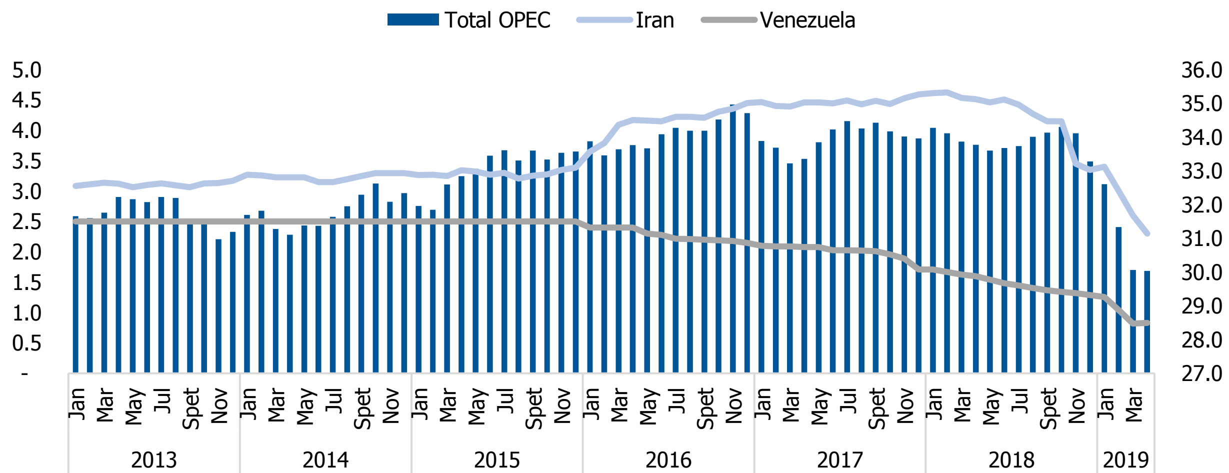
Source: Boursa Kuwait, Tadawul

The move is anticipated to boost liquidity in the stock market and inflow of capital on the Kuwait exchange by arousing its international appeal. The implementation of final phase will also be an important step that could further boost the prospect of inclusion into MSCI's emerging market index. Kuwait currently has a weightage of 23.7% in MSCI frontier market index. Upon upgradation to emerging market, it is expected to have a weightage of 0.5% in the MSCI Emerging market index.

2. How will trade war, Iran sanctions, OPEC supply cuts shape Oil markets in 2019

Average crude oil prices have trended upwards for four consecutive months in 2019. The perception of oil risk due to factors like increasing geopolitical tensions triggered by the drone attack on Saudi oil vessels, the end of waivers for US sanctions on Iranian crude exports, unrest in Venezuela and sustained production cuts from OPEC may have all contributed to these higher oil prices. U.S. Energy Information Administration (EIA) reported that Venezuela's oil output fell to 830,000 barrels per day (bpd) in April, down 10,000 bpd from March and a 700,000 bpd decline from April 2018. Iranian crude oil production averaged 2.3 million bpd in April, down 300,000 bpd from March.

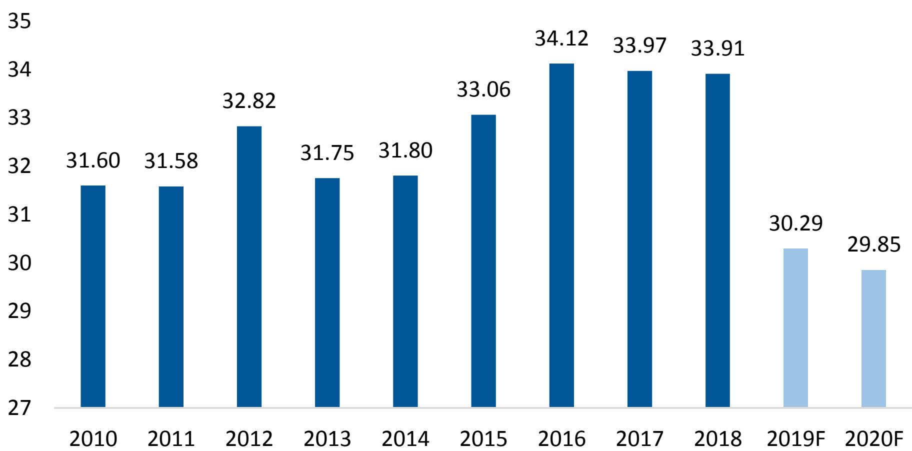
Impact of Sanctions on Iran and Venezuela on OPEC production figures (Million Bpd):



Source: EIA Short-Term Energy Outlook May 2019

The future impact of lower supply from Iran and Venezuela is clearly reflected on EIA's OPEC oil output forecasts, which is expected to average 30.29 million bpd in 2019 and 29.85 million bpd in 2020, down 240,000 bpd and 420,000 bpd, respectively, from its April forecasts.

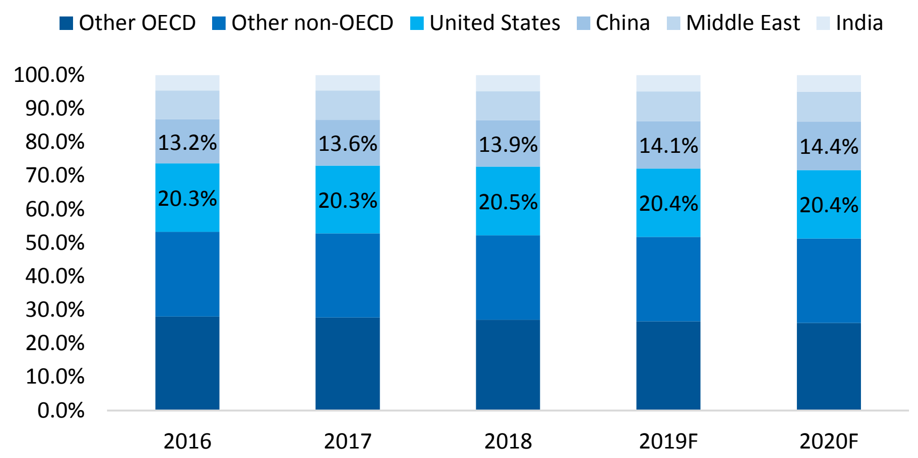
OPEC Crude Oil Production Forecast (Million Bpd)



Source: EIA Short-Term Energy Outlook May 2019

On the other hand, the trade war between the two largest economies in the world has introduced demand concerns affecting market sentiments contributing to a downward pressure on oil prices. US President Donald Trump raised tariffs on USD 200Bn worth of Chinese commodities from 10% to 25% and China has retaliated with its own tariffs on USD 60Bn US goods as high as 25%, from the original 10%. The trade war has increased fears of a slowdown in global demand for liquid fuels consumption as US and China together accounted for 34% of global oil consumption as of 2018.

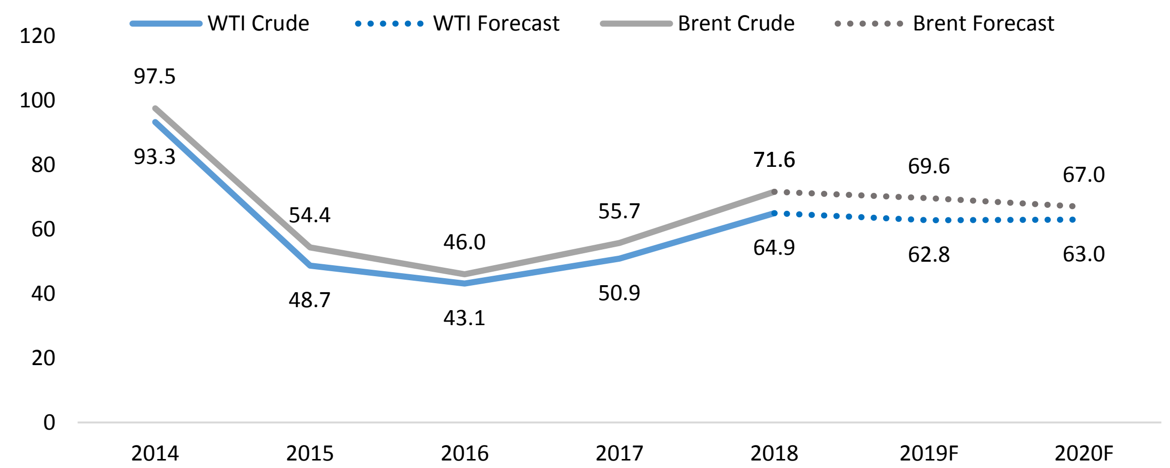
Annual world liquid fuels consumption (Million bpd):



Source: EIA

Emphasizing more on supply constraints, EIA has forecasted that Brent spot prices will average USD 70 per barrel in 2019 and USD 67 per barrel in 2020, both about USD 5 higher than its April Outlook. It also raised the 2020 WTI price view to USD 63 and Brent view to USD 67 per barrel.

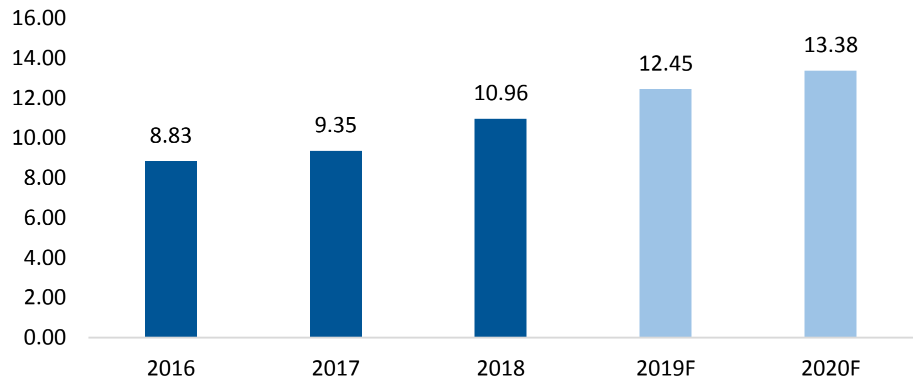
EIA Oil Price Forecast (USD per barrel):



Source: EIA Short-Term Energy Outlook May 2019

Furthermore, EIA predicted, in its short-term energy outlook, that these higher prices would incentivize US to boost production forecasting US oil production to average 12.45 million bpd in 2019 and 13.38 million bpd in 2020, up 150,000 bpd and 350,000 bpd from its April forecasts. US is expected to become a net exporter of crude oil by the end of 2019.

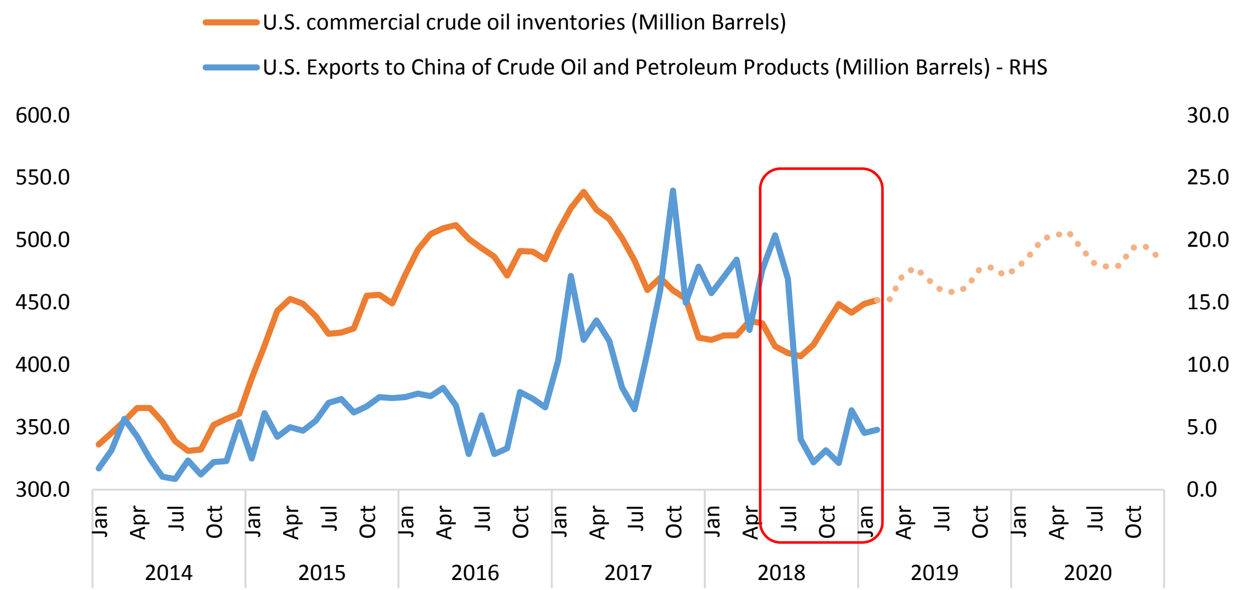
US Crude Oil Production Forecast (Million Bpd):



Source: EIA Short-Term Energy Outlook May 2019

The trade war has greatly reduced shipments of U.S. crude to China, and it is unlikely that Chinese buyers will sign long-term offtake agreements with U.S. crude exporters as long as trade uncertainties continue[2]. In the first half of 2018, China was the third largest importer of U.S. crude, averaging 567 thousand bpd. In the six months ended February, the most recent data available, it has dropped to the fourteenth spot, importing an average of just 129 thousand bpd. US crude oil inventory has been on the rise and if demand from China remains depressed, the market could witness further rise in inventory levels, which might lead to production cuts by the oil companies to keep prices afloat.

U.S. Exports to China of Crude Oil and Petroleum Products (Million Barrels):



Source: US Energy Information Administration, Marmore Analysis

[2] Reuters- china-not-signing-deals-to-buy-u-s-crude-oil-enterprise-

Several external factors have also contributed to the volatility in oil prices in the recent past. The contamination in Russia's Druzhba oil pipeline, which boasts a carrying capacity of 1 million bpd, and is a key channel for crude into Eastern Europe and Germany, has hit Russian oil exports. Furthermore, Saudi Arabia halted its main cross-country East-West oil pipeline temporarily after a drone attack damaged pumping stations along the link. The pipeline, which bypasses the Strait of Hormuz, has a capacity to carry 5 million bpd of crude acting as a strategic transporter of oil for the region. A week prior to the attack in Saudi Arabia, UAE's strategic port of Fujairah witnessed an attack on several oil tankers disrupting trade in the region. Iran has been blamed by Saudi Arabia and UAE for both of these incidents leading to further escalation of political tensions and an upward pressure in oil prices. Oil prices found additional support after tensions escalated when US Maritime Administration reported that US commercial ships including oil tankers sailing through key Middle East waterways could be targeted by Iran, in retaliation of which US sent an aircraft carrier and a bomber taskforce to the region.

With the price of Brent crude hovering in the range of USD 70-75 per barrel in May, Russia might press for a relaxation of the ongoing output restraint in its upcoming OPEC meeting in June. However, with rising US inventories and uncertainty over future demand for oil in the face of the ongoing US-China trade war, Saudi Arabia might extend the deal yet again leading to a potential conflict of interest between the de-facto leaders of the OPEC plus group.

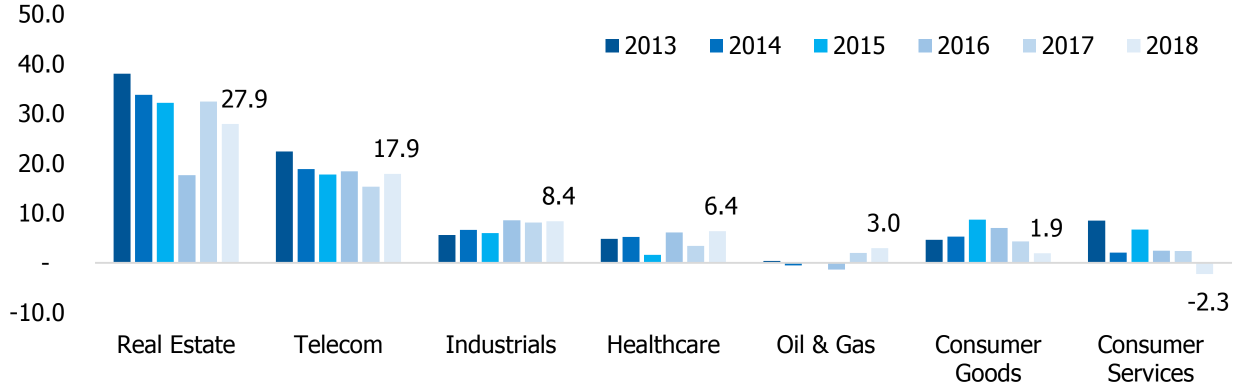
US-China trade war worries are expected to continue to keep a downward pressure on oil prices. EIA expects some tightness in global oil markets during the second and third quarters of 2019, but anticipates that growing production in the United States and key OPEC countries will ensure that global supplies continue to meet demand moving forward. Increased crude oil production in Saudi Arabia, United Arab Emirates, Kuwait, and Russia are likely to backfill the lower Iranian production, though the decision of increasing production will be clear after the OPEC June meeting.

3. Operating Margins of Kuwaiti Stocks – Real Estate faces margin contraction

Businesses in Kuwait have witnessed several challenges in the recent past due to volatile macroeconomic conditions that include swings in oil prices, change in interest rates and geopolitical events. The slump in oil prices during 2014/2015 made operating conditions difficult for the businesses in the country and affected their profitability. However, oil prices rebounded in 2018 and stabilized at healthy levels. Kuwait government has also taken efforts to revive the non-oil sectors through infrastructure spending. Amidst these varying operating conditions, we analyse how the profitability of companies in Kuwait have fared across different sectors. We use the operating margins of publicly listed companies (excluding banking, insurance and financial services) as the metric to identify trends in profitability. We excluded Utilities and Technology sectors due to limited availability of listed companies. Our analysis includes 93 companies spread across Real Estate (38), Industrials (28), Consumer services (11), Oil and Gas (6), Telecom (4) Consumer Goods (3) and Healthcare (3) segments.

Operating margin measures the amount of profit made by a company per unit of sales after accounting for variable operational costs such as wages, cost of raw materials and other costs of production. Operating margin is an indicator of a company's profitability from its core operations. Operating margin is generally a better indicator of profitability compared to net profit margin as it focuses solely on business operations. However, comparing operating margins between sectors on an absolute basis would not be very accurate as certain industries operate at high margins due to the nature of their business.

Operating Margins - Kuwait



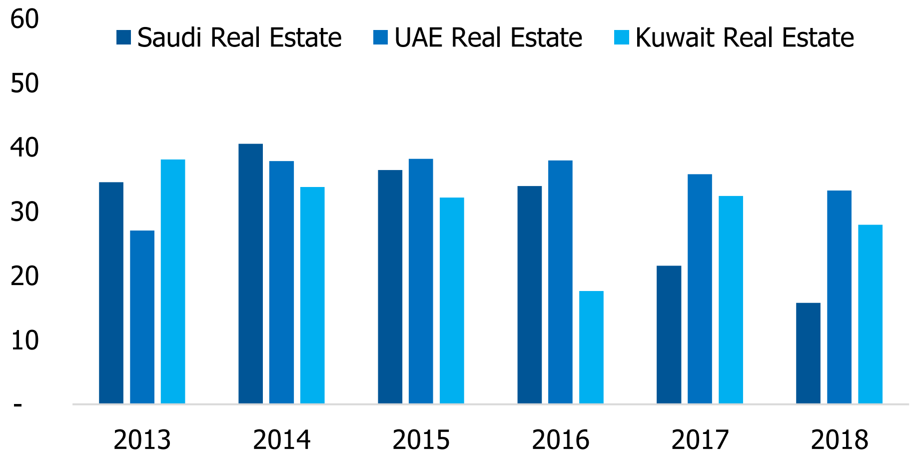
Source: Reuters, Note: Industry classification in accordance with Boursa Kuwait;

Sector trends in Kuwait indicate that Telecom and Real Estate sectors have historically operated with the highest operating margins. However, their margins have been exhibiting a downtrend since 2013. Telecom and Real Estate companies have sizeable presence among Kuwait's listed companies, accounting for 27.5% and 18.7% of the total market cap respectively of non-banking, insurance and financial service companies. Industrials is another sector with a large presence among non-BFSI companies with a share of 30.1%. Operating margins have remained flat for industrial sector stocks in the past three years. Healthcare sector witnessed the biggest margin expansion across sectors in 2018, increasing from 3.4% in 2017 to 6.4% in

2018. Consumer services and Consumer goods on the other hand have seen their margins decline from 4.3% and 2.4% in 2017 to 1.9% and -2.3% in 2018 respectively. The uptick in oil prices has helped oil and gas companies return to profitability, with their margins gradually increasing to 3% in 2018 from -1.4% seen in 2016.

The operating margins of real estate stocks peaked in 2013 at 38.1% and have gradually declined ever since. They reached their lowest point in 2016, reaching 17.6% due to a dip in real estate sales in Kuwait. Real Estate companies across the region have been under pressure due to the sluggishness in the property market. Property prices and Rents have undergone a correction due to oversupply. Dubai has been the worst affected with property prices falling by nearly 27% at the end of 2018 when compared to mid-2014. Despite the slump in Dubai's property market, the operating margins of UAE Real Estate companies have remained higher than that of Kuwait, with UAE companies outperforming their Kuwaiti counterparts consistently since 2014. As real estate companies listed in the UAE are much bigger in size and have a wider geographic outreach, they have been able to overcome the weakness in regional markets unlike Kuwait real estate players. Mabanee Company is the largest Real Estate player listed in Kuwait's market and is the only real estate stock classified under Kuwait Premier Market. Mabanee Company's operating profit margin in the past five years has been higher than the industry average at levels of above 60% due to its strong rental portfolio and its order book containing several expansion projects within and outside Kuwait.

Operating Margins of GCC Real Estate companies



Source: Reuters

Telecom sector's margins have also exhibited a negative trend, coming down from levels of 22.4% in 2013 to 18.9% in 2014 and remaining at an average of 17.7% between 2014 and 2018. Kuwait's high mobile penetration has been one of the driving factors for the growth of telecom companies in the past. With the mobile phone market reaching a saturation phase and offering very little room to grow, margins have continued to stay under pressure. Fixed broadband is one business segment that has been showing promise and offers growth potential. As fixed broadband penetration is much lesser in Kuwait when compared to other GCC countries, telecom operators are expected to target this segment in the coming years to grow their revenues. Development of the e-commerce space and the increase in consumption of content through mobile platforms augur well for the growth of the industry through higher levels of data usage, though competitive pressures may reduce the usage costs. Zain Telecom is the market leader in Kuwait's telecom space in terms of market capitalization and revenue. Zain telecom is one of the largest telecom players in the MENA region, with the highest market share in Kuwait, Iraq, Jordan and Lebanon. Its operating margins have stayed above the industry average throughout the period between 2013 and 2018, as it has been able to expand its presence within the MENA region, while also maintaining a higher ARPU than its closest regional competitors like Ooredo in several markets.

Kuwait's budget policies and its vision have clearly indicated the country's intention to diversify away from oil and develop its non-oil sectors. Therefore, it becomes imperative for the government to support the non-oil sector companies by making the operating environment favourable for them to thrive. With government support and improvement in economic activity, operating margins could be expected to improve in the near future.

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