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Damascus looks to investment banks

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Syria aims to shift the trading in its bourse up a gear. Its strategy has been to allow the establishment of investment banks to add more depth to the country's free market economy

In numbers

$425m: The minimum capital level for investment banks in the DSE as of July 2010

$200m: The minimum capital level for Syrian commercial banks

Source: MEED

Syrians have had to wait more than 45 years for the return of a stock market, after years of a centrally planned state-controlled economy. Now, one year after the Damascus Securities Exchange (DSE) flung open the doors to its trading floor, many could be forgiven for failing to notice that the bourse is up and running.

> The authorities really want the big fish to set up shop … able to cough up more than $400m in minimum capital

Trading remains thin, volumes low and just 17 stocks are represented on the exchange. If Damascus was looking for a slow-burn re-entry into the free market, it has achieved it.

Not that the Syrian authorities appear overly concerned. The low-key start should come as no surprise, as the government has adopted a softly-softly approach to economic reform since President Bashar al-Assad embarked on his plan to drag Syria's economy into the 21st century in 2004. The DSE was years in the planning and was never going to be rushed; launching in March 2009 in the midst of a sharp international financial crisis clearly did not help.

Decisive moves by the Syrian government

The authorities have attempted to kick-start the listing process with a range of incentives, though with little to show for it. In December 2009, the government eased listing requirements on the DSE, with listed companies on the official market having their minimum capital reduced from $6.5m to $2.5m.

More recently, the government has undertaken more decisive moves that are intended to provide greater depth to Syria's nascent capital market. In late July 2010, presidential decree Law 56/2010 was issued allowing the establishment of investment banks. The measure seemed overdue – opening up a stock market without regulations in place for investment banks looked like putting the cart before the horse.

> [Syria wants] to attract the investment banks with expertise … in complex financing deals and big capital projects
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> Joude Badra, Bemo Saudi Fransi Finance

At the very least, the new law provides the regulatory backbone for the creation of investment banks that can take the Syrian capital market onto a higher level. But the imposition of a high minimum capital level of £Syr 20bn, ($425m), has set the bar extremely high for what is still a frontier market. To put this in perspective, the $425m minimum capital level is twice as high as the minimum level for Syrian commercial banks – $200m – a level already criticised as being too high. It is also significantly higher than for financial services that have applied for brokerage licences.

Under the law, founding shareholders must contribute a minimum of 25 per cent of the capital when applying for an investment banking licence, and the ownership ceiling has been raised from 25 per cent to 49 per cent for institutions already active in the financial sector.

Though not explicitly defined, the likelihood is that non-Syrian entities will be allowed to take majority holdings in the new investment banks. The presidential decree states that the cabinet has the discretion to allow non-Syrian share to increase in line with the provisions of Law 28, the banking law amended in 2010 to allow foreign investors to own up to 60 per cent of local commercial banks.

The Syrian government's investment strategy

The banking law includes provisions that the funds raised from loans, bonds and investment certificates must not exceed 10 times the paid-up capital. It also provides for the full range of investment banking services, including M&A advisory services and trading in securities.

The move is part of a wider government strategic effort that envisages the private sector contributing at least 60 per cent of the total required investment of $230bn in the five years from 2011 to 2015. Without a functioning capital market, the government acknowledges it will stand little chance of attracting anywhere near this kind of investment.

The high minimum capital bar reflects two things: First, the government is confident that the potential of a market of 20 million people that has only recently moved to a free market economy is sufficiently high that it can attract the world's leading investment banks. As evidence, it can point to the bid in March 2010 by EFG Hermes, the Middle East's largest publicly traded investment bank, to open an office in Damascus with a prominent local partner and start up a Syrian private equity fund.

Second, it signals that the authorities really want the big fish to set up shop – the credible players comfortably able to cough up more than $400m in minimum capital.

"The move suggests that the government has in mind the larger financial institutions that can make more significant lending possible," says a senior Syrian investor. "High capital requirements for investment banks reflects the fact that they need larger institutions that can participate in real developments, for example the major BOT projects planned here. That is the crux of the issue."

The early experience with commercial banks has convinced the Syrian authorities that only well-capitalised institutions can play a key role in moving major projects ahead. With public-private partnerships (PPPs) intended to be the model for future economic development in Syria – with a pipeline of $5bn of PPP schemes in the works – these projects have struggled so far to secure financing. With low collateral, it has proved a challenge for banks to find the necessary finance.

Gaining traction

Reaching out to investment banks could help solve this problem. "They want to attract the investment banks who have expertise to participate in complex financing deals and large capital projects," says Joude Badra, associate chief operating officer at Bemo Saudi Fransi Finance.

The struggle to gain traction on some of these PPP projects has reinforced the need to develop a fully functioning capital market where local firms can raise capital more cost-effectively. That requirement has been made clear in their faltering attempts to reach out to private equity funds.

"The government decided to reach out to private equity funds last year, but these have been reluctant to launch as there is no exit opportunity for strategic buyers who would normally go to the capital market – the capital market in Syria simply isn't developed," says Badra.

The DSE itself will form a critical component of Syria's new investment landscape. The bourse should eventually feel the impact of changes to the investment banking framework, but it will be a long time before the exchange will be able to play its full and proper role.

The regulator, the Syrian Commission for Financial Markets (SCFM) has adopted a close oversight role, with a sharp eye kept on trading. Daily share movements are limited to 2 per cent, and investors cannot deal in a single stock more than once a day.

This has had negative consequences for the DSE, which is still only conducting four trading sessions a week. "The lack of activity is down to the 2 per cent rule, which means that if you are taking long positions and want to sell, you have to wait," says the investor.

There is also a concern the SCFM is taking too close an interest in IPO prices, micromanaging a process that should be determined on the free market. "If an investment bank approaches a company to take it public, it has to go to the regulator and the regulator will express an opinion about IPO prices," says the investor. "The SCFM is asking why IPO prices are at this level, not that level – invariably, to protect smaller investors, they end up having an IPO price that is a little lower than companies would like."

The end result is that IPOs are being priced too low and investors are unable to let go of their holdings for some time due to the 2 per cent law. "It's a two-pronged problem. First, IPO prices are low – investors want to get a price lift on the second day of trading, but due to the 2 per cent law they are stuck with people taking long positions. New buyers might be coming in, but no-one wants to sell," says the investor.

The investment bank decree should facilitate the process of taking more of Syria's dominant family business sector public. "A lot of family businesses have already prepared themselves internally, revaluing their assets and cleaning up their books. What they are all waiting for is another family business to start the process. Once they see one IPO, there will be six or seven following suit," says Badra.

Investment banks could play a key role in advising on the more complex IPOs expected from conglomerate family businesses, which may be beyond the capabilities of local brokerage houses.

There are already tax advantages for companies looking to float, with a tax rate of 14 per cent compared with the main 25 per cent corporate tax rate for non-listed companies. When conditions are ripe, companies have proved capable of attracting strong investor interest. In the fourth quarter of 2009, Syria saw the biggest IPO in the Middle East, with a $37m offering in Al-Baraka Bank Syria.

Unleashing liquidity for the Syrian economy

Rumours in the market suggest at least three new IPOs are in the pipeline.

There are also reports that Gulf banks including National Bank of Kuwait and Abu Dhabi National Bank, are considering taking up Syrian licences.

The opportunities on offer in Syria for those with patience and large capital reserves are substantial. Huge volumes of customer deposits are currently sitting idle in bank accounts. The move to create investment banks could help to furnish more creative ways to unleash this idle liquidity and create financing for small and medium enterprises, the backbone of Syria's economy.

The challenge is clear: The DSE needs to gain traction if family businesses are to go public and state-owned enterprises are to be privatised.

The early hiccups should be cleared up over time. "Mostly, these are technical issues that can be easily resolved – it's not that there's anything inherently wrong with the stock market. Things such as the 2 per cent law are simple structural issues that need to be addressed, but at the moment the regulator is saying, yes, we understand, but we want to take it slowly," says the investor.