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Capital Raising Activity and Firm Growth in the Arab Region

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In a nutshell

- *Capital raising through equity, bond, and syndicated loan markets by firms in the Arab region has grown rapidly since the early 1990s and involved an increasing number of firms.*
- *Although the bulk of equity is issued domestically, Arab debt issuances are mostly funded from abroad, display lengthy maturity structures, and entail low levels of credit risk.*
- *Issuing firms from the Arab region are very large compared to international standards, the majority of which are, from the financial and utilities sectors. They also tend to be larger, faster growing, and more leveraged than non-issuing firms in Arab countries.*

Since the early 1990s, many countries in the Arab world have embarked on significant financial and economic reforms, involving internal and external financial liberalization, as well as efforts to increase the depth, scope, and efficiency of their financial systems. At the same time, Arab financial systems have shown considerable improvements over the last two decades. In this context, the use of equity, bond, and syndicated loan markets has rapidly expanded in the region since the 1990s, even relative to GDP, which stands in contrast to the relative stagnation in traditional bank credit.

During this period of fast expansion in Arab financial markets, to what extent have firms used equity, bonds, and syndicated loans to obtain financing? How many and which firms issued securities in those markets? How did the assets, turnover, and number of employees of issuing firms evolve relative to non-issuing firms? Despite their importance, these questions have never been previously researched for firms in the Arab world.

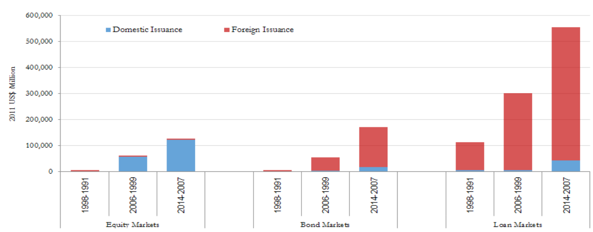
Capital Raising Activity in the Arab World

Over the two decades leading to 2014, there has been a considerable increase in the issuance of equity, bonds, and syndicated loans in Arab countries. The gross amount raised by firms in these markets increased almost 21-fold, 22-fold, and five-fold, respectively, between 1991-98 and 2007-14 (Figure 1).

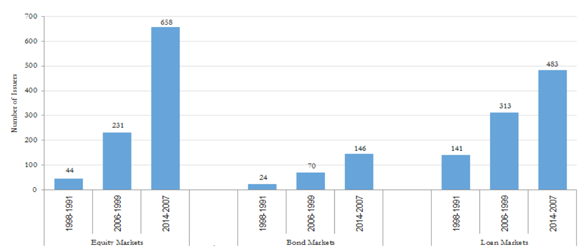
However, whereas most of equity market issuances take place domestically, the bulk of debt issuances by Arab firms are concentrated in foreign markets. International issuances accounted for less than four percent of the total capital raised in equity markets, compared to 89 percent and 92 percent of the total in bond and loan markets during 2007-14. In other words, the reported expansion in debt issuance in the Arab region was driven by a more intensive use of international markets rather than domestic ones, which remained highly illiquid over the period.

Figure 1. Issuance Activity in the Arab Region

A. Amount Raised



B. Number of Issuing Firms



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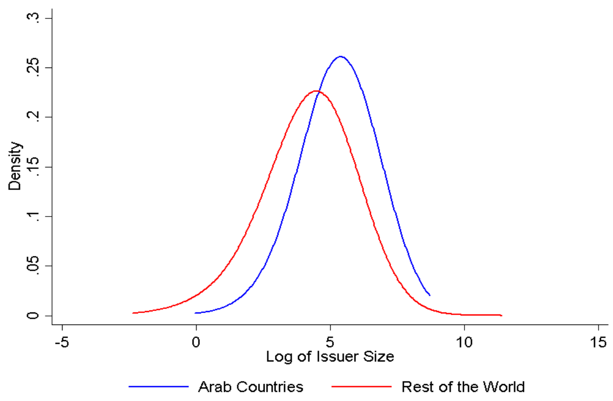
Almost all the funds raised with foreign debt and a large share of domestic debt issuances (around 49 percent) are denominated in foreign currency. However, Arab firms have been using these markets to borrow long term, reducing the risks associated with rollover and foreign currency financing. Bonds issued by Arab firms have the longest (value) weighted average maturity in the world (11.5 years), whereas syndicated loans present the second longest (8.9 years). Bond issuances also entail low levels of credit risk compared to other developing regions. According to Standard and Poor's credit ratings, almost 44 percent of the bonds raised by firms in Arab countries are rated between A- and AAA.

Looking at the different countries in the region, there is considerable heterogeneity in market activity, with the bulk of trading concentrated within a limited number of countries. More specifically, Gulf Cooperation Council (GCC) countries captured around 80-90 percent of the total amount raised in equity and debt markets; during the period 1991-2014. Those are rather high shares considering that such countries accounted for around 66 percent of the region's total GDP during the same period. Saudi Arabia and United Arab Emirates seem to be in the lead, with the latter accounting for almost 60 percent of bond issuances in the region. Among non-GCC nations, the Arab Republic of Egypt has the most active markets, followed by Morocco in equity and loan markets and Tunisia in bond markets.

Which Firms Use Equity, Bond, and Syndicated Loan Markets?

The low levels of credit risk and long-term maturities indicates that only very large firms access (international) bond and syndicated loan markets in these countries. In other words, only the very large firms issue equity, bonds, and syndicated loans in the Arab region, which are also very large by international standards. The firm size distribution (FSD) of Arab issuing firms lies to the right of the FSD of issuing firms from the rest of the world (Figure 2). The fact that Arab issuers are on average larger than those from other regions also implies that a relatively smaller proportion of firms access and benefit from those markets in the Arab region.

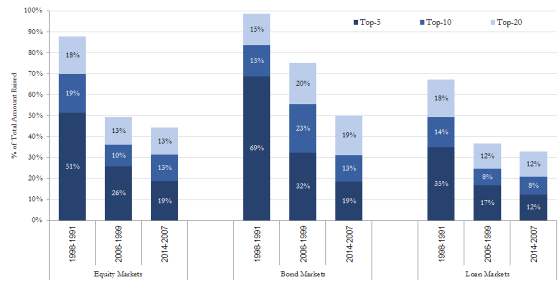
Figure 2. Size Distribution of Issuing Firms



Note: This figure shows the FSD of issuing firms from Arab countries vis-à-vis that constructed with data from the rest the world. The size is reported in logs of Million USD in 2011. Densities are estimated using the Epanechnikov kernel function.

Although only large firms participate in these markets, the number of issuing firms in the Arab region has risen substantially, indicating an expansion in the extensive margin. In particular, the total number of issuing firms has increased 15-fold in equity markets, six-fold in bond markets, and three-fold in syndicated loan markets between 1991-98 and 2007-14 (Figure 1). These findings stand in contrast with other regions in the world, where the expansion in capital market issuance activity has been mainly associated with a growth in the intensive margin (Didier and Schmukler, 2013; Didier et al., 2015). The expansion in these markets has also been associated with a decrease in firm concentration, as illustrated by the decreasing proportion of capital raising activity captured by the top five and top 20 issuing firms (Figure 3). Moreover, the increasing use of these markets has been largely driven by firms in the financial and utilities sectors. Arab firms in these two sectors combined absorb more than 60 percent of the total amount issued in equity, bond, and syndicated loan markets.

Figure 3. Market Concentration
Total Raised by the Top Five, 10, and 20 Issuers as a Percentage of the Total Amount Raised



Note: This figure shows the total amount raised per period by the top five, 10, and 20 issuers in equity, bond, and syndicated loan markets as a percentage of the total amount raised by firms in each of those markets.

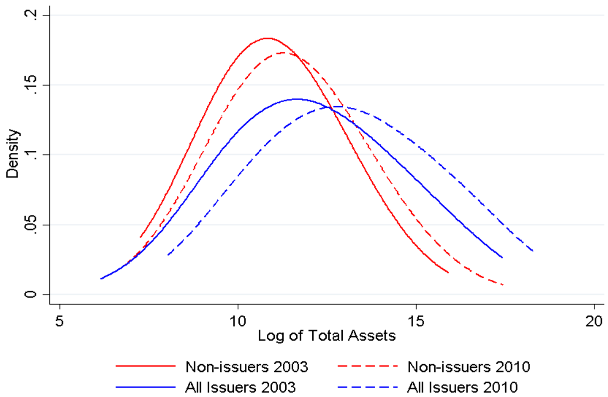
Issuing Activity and Firm Characteristics

Arab firms that issue equity, bonds, or syndicated loans are larger than non-issuing firms within the region as they have more assets, turnover, and employees. For instance, although Arab issuing firms account for 44 percent of the total listed firms, they capture around 90 percent of the total assets, 80 percent of the total turnover, and 70 percent of the total number employees registered by those firms. During 2003-11, the median equity-issuing firm had assets of around 179 million USD, almost three times the assets of the median non-issuer. Debt and especially bond issuers are even larger than equity issuers. Issuing firms are also more leveraged and hold more long-term debt compared to non-issuers.

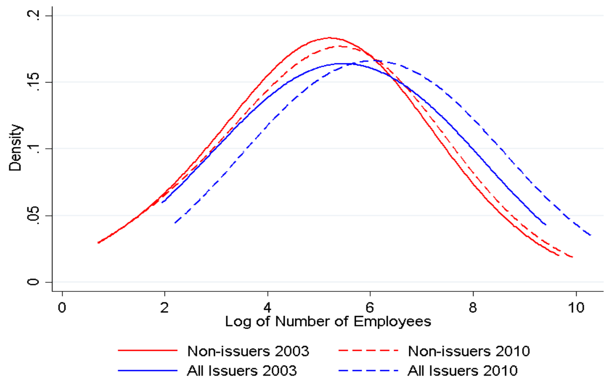
Despite their larger size, issuing firms also tend to grow faster than non-issuing firms. For instance, the average growth rates in assets (turnover) for the median equity issuer and non-issuer were around 14 (17) percent and six (12) percent per year, respectively, during the sample period. In other words, although issuers and non-issuers have both grown in size over time, the former have grown at a faster pace, widening the size difference (Figure 4). Although we do not evaluate the causal impact of a firm issuing equity, bonds, or loans on a firm's performance, these findings indicate that the largest, fastest growing firms are the ones actively using capital markets in the Arab region.

Figure 4. Firm Size Distribution
Issuers vs. Non-Issuers

A. Total Assets



B. Number of Employees



Note: This figure shows the estimated kernel distributions of firm size for issuing and non-issuing Arab firms, in 2003 and 2010. It uses the log of total assets and number of employees as proxies for size. Issuing firms are those that raised capital through equity, bonds, or syndicated loans between 2003 and 2010. Non-issuing firms are those that did not issue equity, bonds, or syndicated loans in our sample.

Policy Discussion

The findings in this brief imply that the development of bond and syndicated loan financing in the Arab region has been related to the use of international markets rather than domestic ones. An open aspect left for future research is to study the supply side of this development. In particular, which types of investors are funding the increasing use of debt markets in the region? The lack of domestic market infrastructure could drive local investors to buy domestic bonds in international markets. However, foreign investors might also be the ones providing debt funding for Arab firms.

The reliance of Arab firms on international markets to obtain debt financing could make their economies prone to external shocks, as most of their funds raised with bonds and loans are denominated in foreign currency. Debt denominated in foreign currency can be risky if not properly hedged, as capital flight and currency depreciations could severely affect firms' balance sheets and increase credit repayment burdens. This issue is worth some consideration because it is mostly Arab firms from non-tradable sectors that are borrowing debt in the markets analyzed here. However, this risk might be mitigated by the fact that Arab firms issue rather long-term corporate bonds and loans, compared to those issued by firms from other regions in the world.

These results also suggest that relatively smaller firms in the Arab world are constrained to other types of financing, such as regular bank loans, internal financing, and trade credit. It might prove difficult for these firms to issue securities in debt markets given the high costs of issuing internationally and the relative illiquidity of their domestic markets. One could argue that Arab countries could benefit from further development of their domestic markets. Well-developed bond markets could allow firms to access alternative sources of funds, promoting a more inclusive and broader use of long-term finance. Moreover, they could increase the competitive pressure on banking systems. By boosting the development of domestic bond markets, less reliance could be placed on international markets, which could also reduce the vulnerability of Arab nations to external shocks.

To conclude, the evidence shows that whereas only a small number of firms issue equity, bonds, and syndicated loans in the Arab region, these are the largest and fastest growing ones. These firms do not just shape their capital structure when they issue; they also grow and enjoy finance investment opportunities. This is important as issuing firms account for a significant part of the total business investment and thus have a major economic impact, with arguably extensive spillover effects over the rest of the economy. These results thus suggest that a wider availability of external finance might allow Arab economies to grow faster. However, more research in this area is needed.

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