Dubai: after the plunge

Summary

- Concerns about Dubai’s potentially crippling default on enormous debts to global creditors have rattled investor confidence across the oil-exporting Gulf region.
- Dubai’s reputation has been impacted in a major way and it will be difficult for the emirate to recover from the negative backlash in the medium to long term.
- However, we believe that Abu Dhabi will come to the rescue… but like all rescues it would have a price. In that case it may well be first of all a political price.
- Abu Dhabi is bound to suffer from the contagion from Dubai for the short term, but we expect the UAE capital will be in a position to overcome any risk profile pressure.
- Credit quality deterioration simply is not an issue in Saudi Arabia, Abu Dhabi and Qatar and we expect that in the short term, investors will calm down and begin to differentiate between “good” and “bad” bets in the Gulf region.

Assessing the regional fallout of Dubai’s credit disaster

Concerns about Dubai’s potentially crippling default on enormous debts to global creditors have rattled investor confidence across the oil-exporting Gulf region, prompting corporate issuers in the region to postpone or cancel bond issuances (e.g. Gulf Investment Bank) in the wake of the news.

We estimate Dubai’s debt upward of $80 billion. At the heart of the issue is whether state-run Dubai World, which holds more than $50 billion in liabilities, will be able to pay back its creditors. The conglomerate that runs flagship Dubai companies such as DP World, asked banks this week for a “standstill” agreement as it negotiates to extend maturities of debt, including the $3.52 billion in Islamic bonds due next month from Nakheel, the famed palm tree island developer. The bond at the centre of Dubai’s restructuring efforts, the December 2009 Islamic bond from Nakheel, has lost a third of its value since the announcement, the price having collapsed to 72 points from 111 beforehand.

Dubai’s announcement, which happened on Wednesday, sent shockwaves through European equity markets on fears that many banks could face massive writedowns on Dubai debt. Currency and bond markets across the globe were also exposed to developments that have become the source of the biggest destruction of confidence in Dubai’s history. To make matters more interesting the ports operator, DP World announced that it will be excluded from the debt standstill and restructuring of Dubai World and its subsidiaries. The company, the world’s fourth-largest ports operator, is 77% owned by Dubai World. DP World is considered the best asset within Dubai World. We think this move is clearly to differentiate the good assets of Dubai from the bad ones, and DP World is a good asset.

Credit default swaps across the region rose, including in Saudi Arabia, Qatar and Abu Dhabi which, unlike Dubai, hold rich hydrocarbon reserves. Dubai’s five-year CDS spreads are at three-month highs and there is further upside risk. Dubai, with sparse oil reserves, built its fortunes on real estate and financial services in recent years, borrowing heavily to finance megaprojects including three man-made islands shaped as palm fronds.
Regional bond sales have been impacted as spreads have widened. Gulf Investment Bank which owned by the Saudi Arabian Monetary Agency (SAMA) and the Public Investment Fund of Saudi Arabia have decided to postpone the dollar bond sale. We are informed that other corporates in the region that were preparing to tap the international bond market. We think that there will be a temporary lull but renewed activity will begin in the first quarter of 2010 as risk is readjusted for the entire region.

Credit quality deterioration simply is not an issue in Saudi Arabia, Abu Dhabi and Qatar and we expect that in the short term, investors will calm down and begin to differentiate between “good” and “bad” bets in the Gulf region. The Dubai debt debacle comes shortly after Qatar, the world’s top exporter of liquefied natural gas, sold $7 billion in bonds this month, subscribed mainly by investors in the United States and the United Kingdom. Orders for the bond issue, described as the largest by an emerging-market government, topped $28 billion – underpinning the genuine faith many international investors have in the region.

We think that in the future, global investors will need to differentiate between those Gulf economies that are debt-burdened and those whose leverage levels are incredibly low by global standards. Saudi Arabia, the world’s biggest oil exporter, has among the lowest levels of public debt in the G20, with domestic debt levels at 13.4% of GDP last year, compared with 81% in India and 50% in the United States. It also holds enormous foreign assets of SR1.46 trillion at the end of October, most of which is invested in low-risk, liquid investments.

**Differentiating regional risk profiles**

In view of these nuances, the region is often wrongly sold to the world as uniform when in fact the six states comprising the Gulf Cooperation Council (GCC) followed very different development models. Even within the UAE, Dubai and capital Abu Dhabi – holder of the majority of the state’s crude oil reserves – had followed two extremely different development paths this decade. Dubai built its economy using high leverage, with revenue streams that were tenuous. Dubai’s volatile real estate and services sectors did well during the boom years but fell victim to the global financial crisis, which triggered a slump in asset values, especially real estate. It should not be ignored that Dubai was above all an interesting real estate play which benefited the early entrants which turned out to be bubble that burst. This approach differs heavily from Abu Dhabi, which was bringing in hundreds of billions of dollars in surpluses during this decade’s oil boom, but investing it in a more calculated, moderate pace that has mainly avoided the creation of asset bubbles. Despite the real estate development story in Abu Dhabi the authorities did not permit the development of a bubble. Dubai is now in a bind as its debt is more than nine time its 2008 revenues. That pattern is unsustainable.

**Once the dust settles, we believe that there will be a flight to quality,** with foreign funds favouring Saudi Arabia, Qatar and Abu Dhabi. Abu Dhabi is bound to suffer from the contagion from Dubai for the short term, but we expect the UAE capital will be in a position to overcome any risk profile pressure. Abu Dhabi controls 90% of the UAE’s oil reserves which are the fourth largest in the world. Despite the global financial crisis, the Abu Dhabi Investment Fund is one of the world’s largest sovereign wealth funds. Clearly, we think Abu Dhabi’s investment program and low key leadership offers reasonable reassurances about the country’s direction to avoid far fewer excesses.

The fate and handling of Dubai’s sovereign risk is impacting the way international markets perceive GCC sovereign risk. The Saad-Algosaibi debt default saga in Saudi Arabia, while shaking the credibility of regional borrowers, did not bring lending to Saudi entities in general to a halt. Rather, the situation forced creditors to reassess the risks involved with lending to different entities and categorise them accordingly. Corporates that are showing signs of transparency will begin to reap the benefits of finance from within the region and outside. However, state entities will continue to receive the bulk of trust from international lenders. In a similar way, Dubai’s debt problems will compel creditors to re-categorize sovereign risk. Dubai entities will have to work hard to convince to bring back
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confidence on the state-enterprise model of Dubai which was based on high leverage and constraint income.

If there is anything we have learned so far from the global financial crisis is that leverage and debt without a strong revenue base cannot sustain an economy. We find Saudi Arabia to be leading the pack in terms of sovereign strength despite the corporate saga that lingers. Moreover, Saudi Arabia and Abu Dhabi never witnessed the real estate excesses that have punished Dubai in the past year.

There was never a real estate bubble in Saudi Arabia and if anything the property market is severely undersupplied. The government has made sure to pay down government debt during the boom years and budgetary spending has been counter-cyclical – careful during periods of high oil prices and aggressive during cycles of depressed oil prices.

We view Qatar as being equally strong as a sovereign, with a solid revenue base to back up its expansion. The excesses witnessed in the property sector were far more contained and used far less leverage, with most, if not all was locally generated. Hence we see very little risk that Qatar can generate going forward.

After the dust settles: what’s next for Dubai

Dubai’s reputation has been impacted in a major way and it will be difficult for the emirate to recover from the negative backlash in the medium to long term. The lack of transparency surrounding how the emirate plans to pay back debts reaching maturity has compounded investors’ perception of risk. Until the Dubai World announcement, investors had expected Abu Dhabi would provide Dubai with adequate funds to pay back its creditors. Just an hour before the debt restructuring news, Dubai announced it had sold $5 billion in bonds to two banks in Abu Dhabi in which the government holds substantial stakes. But the government quickly clarified these funds had nothing to do with the Dubai World debt restructuring.

Earlier this year, the UAE central bank, based in the UAE capital, subscribed for $10 billion in Dubai sovereign bonds, a portion of which went toward enabling state-linked developers pay outstanding dues to contractors. That move eased investor worries about a potential default by Dubai, but also raised questions about what Abu Dhabi would demand in return. The two emirates, although being part of the same federation, are run by separate ruling families.

The entire debt repayment scenario has now been thrown into question. The Nakheel bond is, after all, the most high-profile of Dubai’s debts and was regarded by many as a litmus test for how effectively Dubai – and Abu Dhabi – would treat maturing debts. Markets, puzzled about why the $5 billion raised by Dubai this week was not going to Nakheel bond creditors, will be watching for news on how the debt restructuring develops and what conditions Abu Dhabi could set for providing funds to pay outstanding loans.

Dubai ruler Sheikh Mohammed bin Rashid Al-Maktoum, also prime minister of the UAE, removed this month key executives who helped shape modern Dubai, including replacing the governor of the Dubai International Financial Centre, Omar bin Sulaiman, and removing the chairmen of Emaar Properties, Dubai World and Dubai Holding from the board of the Investment Corporate of Dubai, a body charged with managing the emirate’s wealth. At the newly reshuffled board of ICD, two of the ruler’s sons were brought in as directors. The change of guard will have to be tested and the results and management style would be watched closely by the international investor community. Moreover, the larger question of succession would be kept at the back of the international investors’ minds.

There has been little public announcement about the conditions attached to Abu Dhabi aid to Dubai and what level of autonomy the emirate would have to forego in exchange for the financial bailout. We believe that in the end, Abu Dhabi will be willing and able to provide adequate funds to enable Dubai to meet its debt obligations. We are not of the view that Abu Dhabi wants to have a “sick cousin” that would jeopardize the well-being of the Federation. Abu Dhabi wants to see Dubai’s economy return to a healthier state as many Abu-Dhabi based businessmen have invested in the property sector and the economy of
Dubai at large. Abu Dhabi will have three avenues to pursue: pay, buy and bail out. This funding, however, will come at a cost not measured in money. Politics in this region is more powerful than simple monetary transactions. But in the end, Dubai will not be able to cover its debts on its own and the de-leveraging process could last not a few months but a few years.

**Bailing out Dubai could be good for the Federation but nothing is for free.** Will Abu Dhabi ask for additional control over Dubai, will this make Dubai less autonomous? As there is no free lunch and all services have to be paid back the price that Dubai might have to pay back to Abu Dhabi is some of its autonomy. Dubai would have to yield to the conditions of its rich neighbour in order to save face among global creditors. It is very difficult for Dubai not to prevent Abu Dhabi from gaining additional influence, both at the level of the Federation as well as bilaterally. And the Dubai leadership’s language has changed and become more supportive of the Federation. The most vivid of all was the comments of Dubai’s ruler who said in earlier in November that people who speculated about relations between Dubai and Abu Dhabi should “shut up,” at an investors’ conference in Dubai. The ruling lines of both emirates are “the same family, not only that but the same tribe, the Bani Yas tribe,” he said. They “ruled many many tribes in the Arabian Peninsula for hundreds and hundreds of years.” It is important to note that it was only in 1996 that Dubai integrated its armed forces into the UAE’s military command. The sense of Dubai’s autonomy was also evidenced after the UAE’s establishment in 1971 where there were border check points, for many years, between Abu Dhabi and Dubai even if both were part of the Federation.

Dubai’s economy, meanwhile, is poised to face another backlash from the debt troubles, which are likely to shake investor confidence in its real estate sector once again and send prices that have already halved in the last year down further. Although Dubai’s property developers, controlled by the state, are trying to control real estate prices by holding back the release of additional apartment units onto the market it could be that prices could very well depreciate further. The emirate could also be forced to introduce further delays to infrastructure projects currently in the pipeline.

We think that Abu Dhabi plays a key role in supporting debt-ridden Dubai. Dubai’s leveraged property play has come to abrupt and crashing end. Going forward Dubai needs to show resolve but also willingness to admit to greater transparency. Dubai also needed to better time the announcement of its debt restructuring. Dubai is in dire straits and Abu Dhabi will come to the rescue but like all rescues it would have a price. **As for the international investor base, it should become apparent to them that Dubai is not core of the GCC and there is far greater depth to the region than remains untapped.**

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