



# Sovereign debt issues raise market confidence

Dubai Inc has been proactive and realistic in its response to the worst financial crisis since the Great Depression. Sovereign and quasi-sovereign debt will help stabilise the debt market in the months ahead, notes **Matein Khalid**.

**T**he Dubai government has taken advantage of the new appetite for emerging market new issues in the global debt market with a successful placement of more than US\$2.5 billion in conventional and Islamic debt. This is a milestone event, as it assures the world financial markets that Dubai has emerged from the worst phase of the recession and crisis of confidence, when the emirate's credit default swaps had spiked as high as 1000 basis points. The successful repayment of the Nakheel sukuk and the US\$10 billion bond purchase by the UAE central bank convinced investors that default risk on Dubai debt was grossly overdone. As investor confidence returned to the debt markets, sovereign issuers from Qatar and Abu Dhabi launched billion-

dollar sukuk that trade well above par in the secondary market, indicating strong demand for GCC debt. This resurgence of risk appetite by international investors and the tightest credit risk spreads since the failure of Lehman Brothers in September 2008 helped Dubai's successful sukuk and Eurobond issue in November 2009. The Dubai government can now manage its relatively modest external debt and refinance the debt of its constellation of state-owned companies, the proverbial Dubai Inc.

## Dubai risk

The US\$4 billion Dubai medium-term note programme will provide the emirate with a diverse, flexible pool of funding, and road shows conducted by the lead manager

banking syndicates in the money centre capital of Europe, Asia and the Middle East suggest that fund managers are very comfortable with Dubai risk, even though the pricing on the emirate's five-year debt was a gift to investors and the bonds trade above par. The Investment Corporation of Dubai has emerged as the flagship holding company of the Investment Corporation of Dubai, which has a 100 per cent stake in Emirates Airline and the Dubai Aluminum Company, a 56 per cent stake in Emirates NBD and a one-third stake in Emaar Properties, the region's bellwether property developer, which is the flagship firm listed on the Dubai Financial Market (DFM).

The state-owned companies of Dubai, such as Nakheel, are estimated to owe US\$70-80



billion. Their debt will be anchored by the Dubai Financial Support Fund, whose loans will be allocated to state-owned companies under strict oversight and using commercial, free market rationale. While Dubai has successfully managed to regain access to the international bond market, the emirate has to resolve the maturing debt challenges of its state-owned companies, whose credit ratings were downgraded by Moody's. Confidence in Dubai Inc was also boosted by the announcement that the government confirmed that it repaid the US\$1 billion Dubai Civil Aviation Authority sukuk as it matured in November 2009.

However, the trauma of 2008-2009 has taken its toll on the market for Shari'ah-compliant debt, the sukuk market. New issue volumes fell 45 per cent in 2009, primarily because UAE borrowers, who accounted for two-thirds of all sukuk new issues in 2008, were largely absent from the markets. Yet, the Dubai issue now allows UAE borrowers other than quasi-sovereign corporations of Abu Dhabi, such as Mubadala, to access the sukuk market. This is mission critical, as the domestic banking system in the UAE has still not

resumed loan growth and the IPO window is de facto closed, despite impressive rallies in both Dubai's DFM and Abu Dhabi's Abu Dhabi Securities Market indices.


For now, the sukuk market is only open to the crème de la crème sovereign borrowers from Abu Dhabi and Qatar. Yet, sovereign sukuk new issues are a prerequisite for the return of UAE corporates, banks, telecoms and utilities to the global debt market. Moreover, the UAE banking system needs to provide greater disclosure about its exposure to the local real estate market, as well as to regional corporate borrowers who have defaulted on their bank debt and loans. UAE banks reportedly have US\$2.9 billion exposure to the Al Saad Group and Al Gosaibi, two large Saudi conglomerates whose US\$20 billion debt default is the largest financial collapse in the Kingdom since the 1970s. The sheer scale of the Saad/Al Gosaibi default has sent shock waves across the banking system. The Gulf has once again paid a high price for the practice of name lending.

## Outlook

The UAE central bank has rightly insisted on a greater emphasis on provisioning risk management and conservative funding profile and non-performing loan disclosure rather than the earlier obsession with breakneck growth and profitability. The UAE banking system needs to reduce its loan-to-deposit ratios and its reliance on offshore wholesale money markets to finance local asset growth, strategies that proved dangerous during the post-Lehman credit crunch when the international bond market snapped shut for emerging market banks, particularly banks whose loan/deposit ratio was higher than 100 or whose loan books were excessively exposed to property loans.

Dubai Inc has been proactive and realistic in its response to the worst financial crisis since the Great Depression. A prerequisite for the revival of the property sector is the reopening of a viable mortgage finance market, which requires that the government successfully complete the merger of Amlak and Tamweel. After all, Amlak and Tamweel control 60-70 per cent of the UAE mortgage market. Moreover, the crisis has proven that Abu Dhabi and Dubai have been more than willing to support each other during

times of crisis, with 2009 becoming a successful real world stress test for the viability of the UAE Federation. Moreover, Dubai's state companies have greatly reassured their creditors by meeting their obligations. After all, more than US\$8 billion in external debt and bonds have been repaid or refinanced by DEWA, Dubai Aviation, DIC, Dubai Holdings and Dubai World. The full repayment of the Nakheel sukuk on December 14, 2009 will be a symbolic milestone that Dubai Inc is committed to the repayment of all its obligations in 2010 and 2011. Meanwhile, the US\$15 billion in sukuk and offshore debt issued by Abu Dhabi quasi-sovereign borrowers has led to the resurgence of international financial flows into the UAE.

UAE stock market indices have surged since the summer, as sovereign credit default risk spreads for Abu Dhabi and Dubai plunged while the crude oil price doubled to US\$80 by October 2009 from its bottom last winter. However, the markets are no longer dominated by foreign institutional investors, as during the bull market of 2006-2008. Retail investors, local corporate and family offices and regional fund managers, shocked by the scale of their losses in 2008-2009, are cautious in their trading, with a preference for value shares. Banks and property developers are still viewed with suspicion by most UAE fund managers who believe that bank loan losses will rise and that property prices have still not bottomed. The stock market is also extremely sensitive to project cancellations and credit downgrades by international rating agencies. However, the outlook for the UAE stock markets will remain bullish as long as oil prices remain high, Dubai state-owned companies can refinance and restructure their external debt and listed companies regain access to local bank credit and global debt markets. In any case, defensive sectors such as telecom consumer staples will outperform banks and property companies. Low beta, high dividend yield, free cash flow is the formula for success when markets are uncertain. 

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