

Dubai debt: What's the best course now?

The development of a long-term bond market is always a good option for an economy in building mode. **Matein Khalid** ponders the immediate issues for Dubai debt, while also wondering if a long-term bond market could be the solution.

Abu Dhabi's US\$10 billion support ensured that the creditors of the Nakheel December 2009 sukuk received full repayment. The Nakheel sukuk literally doubled in price from 52 to 109 when the announcement of the Abu Dhabi repayment hit the newswires, an act that averted a default event that would have proved catastrophic for the UAE's financial ecosystem. Yet, the resolution of the Nakheel 2009 sukuk does not mean a resolution of Dubai's broader debt dilemma. For one, Dubai borrowers no longer have access to the international capital markets. Moreover, Abu Dhabi's support is not an implicit government guarantee on all the outstanding debt by Dubai's quasi-sovereign borrowers. Rather, it is support based on a case-by-case approach to an orderly restructuring.

The Dubai World restructuring includes both private bank debt and public debt, and the risk premium on Dubai sovereign credit default spreads and sukuk/Eurobond debt will only fall once the capital markets are convinced that a restructuring template unites both issuer and creditors, making a resolution possible. This process, in turn, will rehabilitate Dubai's credit profile and reopen access to the international capital markets with Abu Dhabi support as the catalyst to kick-start the process.

It is necessary for Dubai to resume access to the international debt market to meet its refinancing requirements in 2010 and 2011. The announcement of the Abu Dhabi support package was conditional on a standstill agreement in place between Dubai World and its creditors, the day before the first installment was due on the Dubai World US\$5.5 billion syndicated loan and the repayment (maturity) of the

Nakheel 2010 sukuk. The successful restructuring of the Dubai World debt would not only reduce the risk premium on Dubai debt, but also set a precedent for the debt restructuring of other state-owned holding companies.

As a former trader of Latin American sovereign debt in the early 1990s, I am under no illusion that sovereign debt restructuring negotiations will not be protracted. The period between initial default and the Brady Plan that securitised Wall Street money centre bank loans into US-Treasury-collateralised long maturity marketable bonds took no less than seven years. I wonder if the securitisation of Dubai Inc bank debt could be a viable idea for creditors, particularly if Abu Dhabi's stellar sovereign risk could be leveraged (in a strategic, not a financial sense!) into zero coupon, long maturity collateral to

guarantee repayment risk. In essence, Abu Dhabi would play the role with Dubai debt that the US Treasury played with Latin American sovereign bank loans in the 1980s.

It is evident that the Dubai government is determined to establish an international best practice legal paradigm for the Dubai World restructuring process. This is itself significant because a restructuring on this scale, complexity and cross-border sophistication is without precedent for the embryonic Dubai International Financial Centre (DIFC) legal tribunal. Apart from the two Nakheel sukuk, which are public bond issues, the vast majority of Dubai's estimated US\$22 billion debt is syndicated bank loans or bilateral borrowings. The two Nakheel issues mature in May 2010 (AED3.6 billion) and January 2011 (US\$750 million). It



is almost impossible to determine the recovery value of private bank debt, as the debt restructuring process is necessarily private. Yet, the resolution of the Dubai World private bank debt is a necessary, if not sufficient, condition for full repayments on the Nakheel 2010 and Nakheel 2011 maturing sukuk. The capital markets, for obvious reasons, will price the two Nakheel sukuk in the secondary market in accordance with the prevailing recovery value assumptions on the private debt.

Obviously, Dubai World will sell assets to repay debt as an integral component of the restructuring process. This could well include New York hotels, London office buildings, the stake in Standard Chartered Bank and MGM. Yet, the fact remains that the crown jewel of the Dubai World empire is DP World and the Jebel Ali Free Zone, which are strategic assets mission critical for the economic development of both Dubai and the UAE Federation, not financial, non-core holdings that could be sold to repay debt.

The fact remains that DP World and JAFZ can generate the cash flows to repay Dubai World's debts as long as the repayment of the bank loans is extended in time and an appropriate recovery value is determined during the restructuring process. The dilemma is that DP World is an emerging markets growth franchise

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that needs to invest in its myriad acquisitions of port operators all over the world during the midst of the worst downturn in world trade and shipping since the Reagan recession of the 1980s. It might also be difficult to rely on free cash flow from the Jebel Ali Free Zone, as its balance sheet is also highly leveraged and it needs to repay its own debt obligations.

This is the strategic context in which DP World management seeks to list in London, probably at a time when sentiment towards Gulf companies and Dubai credit is more positive, something I expect to see after the May 2010 sukuk repayment. A London Stock Exchange listing would reflect the global nature of the DP World business model, but also enable Dubai World to unlock billions of dollars in shareholder value.

It is premature to speculate on recovery levels on the Nakheel sukuk, since so many variables are unknown. My base scenario, however, assumes 50-60 per cent nominal recovery. I expect the restructuring process to include a cash component with a negotiated

haircut, with the remainder of the debt owed rescheduled at a higher rate of interest and a longer maturity, but with full repayment to the creditor. This was generally the formula in the sovereign debt rescheduling of Brazil, Mexico, Argentina, Indonesia, Poland and the Philippines two decades ago. Obviously, Dubai World will propose a restructuring formula and financial model to its creditors, whose acceptance will be a protracted and probably tough negotiation process. Professor Von Neumann's mathematical model of game theory, particularly the cooperation-conflict payoffs in the Prisoner's Dilemma, could well help investors understand the myriad, complex, real life strategic choices that face both Dubai World and its international bank and bond creditors.

A salient issue in the Dubai World restructuring is the valuation of 60 million square feet of Dubai waterfront land. Historical valuations or even current market prices based on a handful of transactions by distressed sellers are meaningless. The AED100-400 valuations ranges on waterfront in 2007-2008 assumed that the land would be developed into a community, a prospect that the credit crunch, Dubai World's debt restructuring and the collapse of Dubai property prices have now made irrelevant. The land has only option value now (i.e. it may or may not be developed in the distant future). This is, of course, a financial wild card for sukuk creditors. It is impossible to calculate recovery value for the 2011 Nakheel sukuk without specific financial intelligence on the value of waterfront land and the precise logistics of its realisable value as collateral. It is also unclear whether Nakheel sukuk holders will rank as senior secured creditors or will be treated by the DIFC tribunal as *pari passu* to the syndicate of bank creditors. It is impossible to model a haircut to trade creditors or payables from customers who paid their deposits. These are precisely the sorts of issues that will be debated by in the current Dubai World restructuring. [www](#)

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