

# BONDS

## Stepping it up in the region

Experts have long emphasised the importance of developing a full-scale debt capital market in the GCC for the past few years, but the current global crisis has given the cause a boost. As bank lending tightened and stock markets bombed, the need for a debt market became urgent. **Ritwika Chaudhuri** reveals what's happening in the region's debt capital market.

If the recent issuances of bonds in Abu Dhabi, Qatar and Dubai are any indications to go by, the development of a healthy debt capital market in the GCC is gaining momentum. Regional sovereign and corporate issuers announced bond issues totalling approximately US\$30 billion in the first half of the current year. Around US\$7 billion was issued in the second quarter alone.

Although the majority of the issuers have been sovereign, a Moody's January report predicted that corporate bond issuances in the GCC could reach US\$50 billion over the next 12 to 18 months, up from US\$23.7 billion in 2007.

The figures do look encouraging, but experts emphasise that the region has much to accomplish in order to establish a matured

debt securities market in terms of issuance, size, tenor and setting a benchmark.

Compared to some of the western markets, the GCC's debt market is nascent at best. Dealogic, a provider of global investment banking analysis and systems, reported the total issuance of global investment grade bonds to be at US\$210



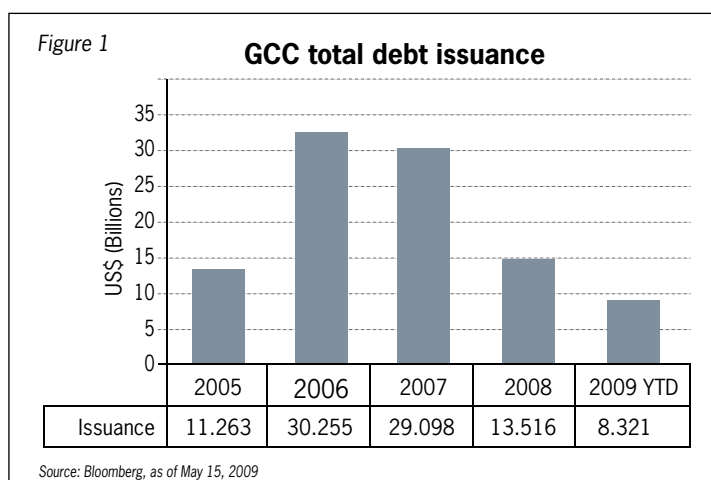
billion as of June 2009, up from US\$159 billion in 2008 and US\$66 billion in 2007. According to data available from Bloomberg, the total debt issuance in the GCC was US\$8.32 billion as of mid-

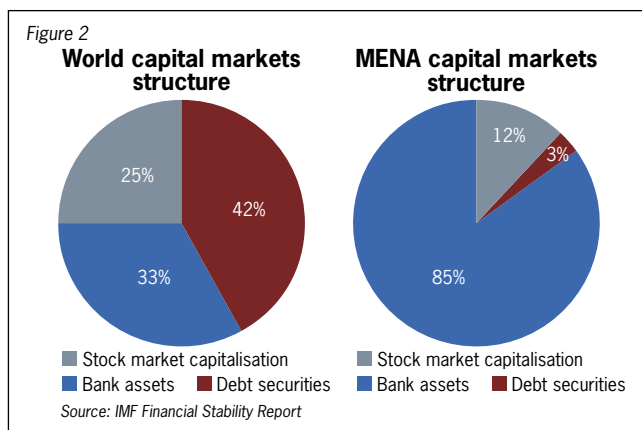
May 2009. In 2008, it was only US\$13.57 billion (Figure 1).

According to an International Monetary Fund financial markets stability report, debt securities constitute only three per cent of

the financial markets in the Middle East and North Africa, compared to 42 per cent of the global financial market (which includes banks, equity and debt markets, see figure 2). In the developed western securities markets, 90 per cent of the turnover is attributable to interest-rate-related securities and only 10 per cent is attributable to stocks, whilst it is the other way around in the GCC.

The series of recent sovereign issuances in the GCC region, however, is a positive development for the regional debt market. Experts say that regional governments are generating a momentum in the GCC fixed-income market by issuing bonds that will ultimately create a yield curve, or a benchmark price structure, that





corporates in the region can follow when issuing their own bonds. What could be a better time for this to happen than now, when banks are reluctant to lend?

“The fact that fixed-income assets guarantee a coupon or interest-bearing element and the return of the original investment (as long as the bond does not default), as well as the more

stable liquidity of the market, makes this asset class increasingly attractive to investors seeking exposure to a relatively more secure investment opportunity,” says Nish Popat, head of fixed income at ING IM Middle East.

At a time when people have lost heavily asset-wise, because of over-concentration in equity and real estate, the introduction of fixed income in a portfolio is now making sense to them. This attitude is a change from the recent past, when people just wouldn't look at anything offering modest returns.

## Current trends

The size of the outstanding GCC bond market debt is approximately US\$115 billion, combining both sovereign and corporate debt, according to the Financial Times.

The Gulf markets have typically been characterised by a lack of benchmarks, a limited number of issuers and low liquidity. Moreover, longer maturity issues have been virtually absent in the market. Prior to the US\$3.5 million convertible bonds from DP World, the GCC bond market was dominated by mid-sized, short maturity bonds, which were mainly issued by regional banks. According to Abdul Kadir Hussain, CEO of Mashreq Capital, it

# Corporate debt market coming soon

Mark Waters, head of debt capital markets for the Middle East at BNP Paribas, tells **MONEYworks** that the debt market is in the process of opening up for corporates in the GCC.

## Why has the debt capital market not developed in this region so far?

Historically, GCC-based corporates have tended to rely on their core banks to support their ongoing financing needs. This has been achieved through bilateral lines but, more importantly, through syndicated loans.

The reliance on the syndicated loan market is also a function of only a limited number of GCC corporates having external ratings, which is a pre-requisite for tapping the debt capital markets.

This will, however, change as a result of the moving market dynamics, which have so far witnessed significantly reduced levels of liquidity within the GCC syndicated loan market on the back of ongoing capital constraints and higher funding costs facing financial institutions in the region.

The consequence of this will mean more and more companies looking to attain external ratings in order to diversify

existing funding sources to facilitate an approach to the bond market.

## Is a relatively lower rate of return the main reason for the debt market not to develop?

Prior to the financial crisis, investors clearly had other potential investment opportunities. However, this is no longer the case with investors finding the equities market far too volatile while cash investments are generating negligible returns.

As such, investors are now focusing purely on the bond market, which is driving the level of record issuance.

## Is the current economic crisis instrumental for concerted efforts by different governments to develop debt capital and a fixed-income market?

This is particularly evident in the US and Europe, where government guarantees, for instance, have been provided to assist



Mark Waters

financial institutions with medium-term bond issuances. The proceeds have been used by banks to support their funding needs and improve their liquidity positions.

To date, this has not been the case in the GCC, as the various governments across the region have been using alternative methods to improve the financial condition of the banking sector. Such measures have included direct equity injections, conversion of state deposits into capital, removal of certain asset types including investments and providing additional liquidity into the banking systems as and when required.

**Bonds issued in the UAE since 1999\***

Currency/ Year	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
US\$	x	NA	x	NA	x	1.63 billion	4.32 billion	8.8 billion	13.65 billion	1.66 billion	23 billion**
AED	750 million	NA	1.5 billion	NA	1.5 billion	500 million	x	4.52 billion	10.25 billion	24.25 billion	x
EURO	x	NA	x	NA	x	x	x	1.25 billion	825 million	25 million	x

Source: Mashreq Capital & NBAD, compiled by: MONEYworks, \*inclusive of sukuks, \*\* inclusive of US\$20 billion Dubai government bond announced

was only after early 2006 that the regional bond market started developing in terms of size, types of issuers, length of maturities, structure of bonds and different currency denominations.

“With the spate of new issuances from regional governments and institutions like Qatar Telecom and Aldar, the liquidity in the bond market has improved remarkably,” notes Hussain.

Some of the recent issuances include the March announcement of the US\$20 billion Dubai government bond programme to ease tight liquidity conditions in the emirate. The UAE central bank subscribed to half of that issue. A second US\$10 billion tranche will be issued as, and when, needed.

The UAE also announced its plans to launch its first sovereign bond fund last month. Though the size and timeframe of the bond

issue are yet to be determined, the bond issue is in the process of being rated. A new public debt law to govern the distribution of funding from the bond sale is also in the offing.

Apart from Dubai, the two biggest GCC bond issues have been the sovereign transactions for Abu Dhabi and Qatar.

The Abu Dhabi government launched two Abu Dhabi sovereign bonds with maturities of five years and 10 years, priced to yield about 5.65 per cent and 6.85 per cent respectively. Issued in April, these bonds will raise as much as US\$3 billion for the emirate.

On April 29, the state-owned Mubadala Development Company sold five-year bonds totalling US\$1.25 billion that were priced to yield six per cent. This occurrence was followed by the issuance

The approach of the regional governments has been more focused on direct sovereign issuances to facilitate subsequent corporate bond issues.

### **What should governments do to develop a debt capital market? What is your opinion about the initiatives taken by Qatar and Abu Dhabi?**

The recent bond issuances by both Abu Dhabi and Qatar were strategically important for their respective states, as the key objective was to facilitate subsequent corporate issuances.

This has already been witnessed in Abu Dhabi with bond issues having already been launched for Mubadala and Aldar.

The same pattern has now emerged for Qatar. The sovereign bond issue has now been followed by US\$1.5 billion dual tranche five- and 10-year issuances for Qatar Telecom, in which BNP Paribas acted as joint lead manager and bookrunner. The Qtel transaction was a huge success, having amassed an order book in excess of US\$13 billion.

### **Is there any indication that the current round of sovereign bonds will be followed by quasi-government and corporate bonds?**

We expect to see an imminent bond issue for the Bahrain sovereign. Thereafter, there is no real clarity on other sovereign bond issuances.

There is definitely an order of issuance within the GCC, which is most definitely required in order to raise the international profile of the Gulf region on a global basis.

The initial push has been with the sovereign bond issues, followed by the state-owned corporate issuance – a plan that has worked well for both Abu Dhabi and Qatar

The market will ultimately open up for private sector issuance within the GCC.

### **Are the current pricing and maturities of the sovereigns attractive enough to be a reference point for corporates?**

Reference points in terms of pricing have been set by the recent sovereign transactions, and subsequent corporate issues would need to be priced off these deals in terms of the required additional risk premium.

Of key benefit to GCC corporates will be the performance of the sovereign bonds in secondary, which has tightened by approximately 100 basis points from the launch levels. As such, new corporate issuance would be priced off the

secondary price, which is clearly a major positive factor for corporates looking to tap the bond market.

With regard to maturities, GCC issues have tended to be a dual tranche of five and 10 years, which represents an optimal structure in terms of satisfying investor interest. We would expect to see similar maturities for future issuances.

### **In the absence of a GCC benchmark for bonds, how would you recommend creating one?**

Benchmarks, or reference points, for potential issuance would include credit default swap levels and secondary pricing levels of outstanding bonds. These would be key indicators when pricing any new bond issuance.

### **Are sukuk a better alternative?**

Sukuk represent a key part of debt capital market issuance in the GCC. Islamic bonds are not necessarily a better alternative, but more of a complimentary fit in terms of assisting sovereigns and corporates with a different source of investor base.

It is important for GCC issuers to maximise all sources of investor interest, which will include Islamic and conventional investors.

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Nish Popat

of a US\$1.25 billion bond by Aldar Properties. The five-year notes were priced at face value to yield 8.75 per cent, according to Bloomberg.

Following the move by Abu Dhabi, Qatar issued bonds totalling US\$3 billion. The issue was split into two tranches: a US\$2 billion tranche maturing in 2014 and a US\$1 billion tranche maturing in 2019. The government stated that the proceeds from these bonds would be used for general funding purposes, including the provision of contingency funding to entities owned or controlled by the government.

Qatar Telecommunication Company said last month that it planned to issue up to US\$5 billion in bonds, partly to help refinance debts.

The market is also expecting a bond issue for the Bahrain sovereign. According to published reports, Bahrain plans to launch a US\$663.3 million three-year

sovereign bond over and above a US\$500 million sukuk issue.

In another important development, the Saudi stock market regulator approved the set-up of a market for debt securities last month, responding to the demand for diversified sources of funding from the market. The Saudi stock exchange – Tadawul – will trade bonds and sukuks through licensed intermediaries, according to the Capital Market Authority.

Experts predict significant growth in the size and depth of the GCC debt market, more specifically the fixed-income market. They expect the growth of the GCC fixed-income market to be driven by a number of factors, including a heightened awareness about fixed income among Middle East investors, who previously ignored the asset class for riskier and more profitable assets.

It was disclosed in a regulators' conference in Dubai last March that regional financial players were planning to set up a professional bond market association. This association will represent the industry on regulatory and legislative issues and initiatives and will convey ideas to regulators and central banks concerning issues such as ways of enforcing bond contracts and protecting bondholders.

### Case for a bond market

The case for a regional bond market has been argued for quite some time, but the current economic situation, as a consequence of the global



economic meltdown, has probably strongly reinforced its necessity. The subject will become even more topical, as some of the regional governments may have to resort to deficit financing for the first time.

At that very same meeting of regulators in Dubai last March, financial market participants admitted that the effects of the credit squeeze could be alleviated substantially with a functioning bond market. Tom Healy, CEO of the Abu Dhabi Securities Exchange, said in a recent press statement that the only real source of liquidity in the UAE was the stock market. He felt that the country needed a vibrant bond market to ensure that enough liquidity remained in the system despite the global crisis.

In 2006, Francesco V. Garzarelli of Goldman Sachs said in a presentation about the case for a local bond market in the UAE: "A bond may represent a spare tyre at a time of banks' distress, avoiding a credit crunch."

When banks in the UAE stopped lending amidst the credit crunch,

### Selected regional issues

Security name	Currency	Maturity	Coupon	Indicative yield	Rating
Kuwait Projects	US\$	12/04/2011	2.25	16.91	BBB+
Ras Laffan Gas	US\$	30/09/2016	5.832	7.045	A
SABIC	EUR	28/11/2013	4.50	7.912	A
Nakheel	US\$	14/12/2009	3.17	47.06	Not Rated
ALDAR	US\$	10/11/2011	5.77	11.55	Not Rated
JAFZA	AED	27/11/2012	5.68	23.54	A+

Source: Mashreq Capital



UAE companies did not have the spare tyre and thus suffered the consequences.

There are some clear advantages of borrowing from the market over bank loans, experts argue. While bank borrowing involves lower refinance risk and fewer disclosures to the public market, there is a larger scope for tactical debt management and less demanding covenants in the case of market borrowing. Bank borrowing comes with managerial counselling or interference, which is missing in the case of market borrowing. Overall, debt instruments facilitate the creation

of financial assets that can complete the market.

Bonds, especially short-term government bonds, pose a reasonably strong case for investment because of their yields. According to a Global Investment House study, regional government bonds that are set to mature within a year give better or similar yields compared to dividend yields in general. The exception is Kuwait, which offers good dividend yields over government bonds. In Bahrain and Oman, dividend yields at current prices are slightly better. The difference is negligible, though, hence reinforcing the importance of bonds (Table 1).

“Bonds are offering better value at present globally. The asset class does not have any downside like equity and one gets paid for waiting,” says Hussain. “But one needs to do one’s homework about the time horizon of bonds, coupon rates and which bonds offer what types of yield.”

### Still miles to go

Despite the flow of issuances in the last couple of years, the GCC bond market is still underdeveloped in comparison to traditional bank and equity financing. There are several reasons why a debt capital or bond market did not develop in this part of the world. In fact, prior to the global crisis, issuing sovereign bond funds was not a high priority for GCC governments, as most were flush with liquidity from high oil prices. Banks were also flush with funds and borrowing and lending was easy, while stock markets could be tapped at any time.

Benoit Anne, emerging market debt and FX strategist at Bank

Table 1

Yield comparison: Dividend vs. Bond			
Country	Dividend yield	Govt bond yield*	Difference
South Arabia	3.91%	3.92%	-0.01%
Dubai	3.41%	4.25%	-0.84%
Kuwait	4.90%	1.88%	3.03%
Qatar	3.25%	5.00%	-1.75%
Bahrain	5.00%	4.50%	0.50%
Oman	5.60%	4.50%	1.10%

Source: Bloomberg

\*Yield on government bond maturing after one year except for Dubai

of America Securities and Merrill Lynch says, "Historically, a bond market has not been a necessity in the GCC as it has been in Latin America and Asia. In the GCC, governments did not have to resort to deficit financing through bonds. Banks played a big role in lending. It is only recently that the need for developing corporate and sovereign bonds was felt as ambitious projects were announced."

Banks that were flush with capital were not interested in the tier II source of capital. Investors were also riding high with the uptrend in the stock market and the unprecedented growth in the property market. Returns were high, so investors did not consider investment instruments offering modest returns.

"Bonds as an asset class have not developed much, as there was no natural demand base due to lack of institutions. Besides, demand has primarily come from institutions, followed by retail investors," Hussain argues.

The other crucial factor has been the supply side, which lacked fixed income. Hussain says that bond or sukuk instruments are still not well understood in this region and that there is a dearth of expertise, even today.

While the necessity of a debt market is being felt strongly and the recent issuances have set a tempo, there still remains an enormous amount of work to be done.

"It has to be a GCC effort as a whole to develop a proper regional bond market. It is also necessary



Benoit Anne

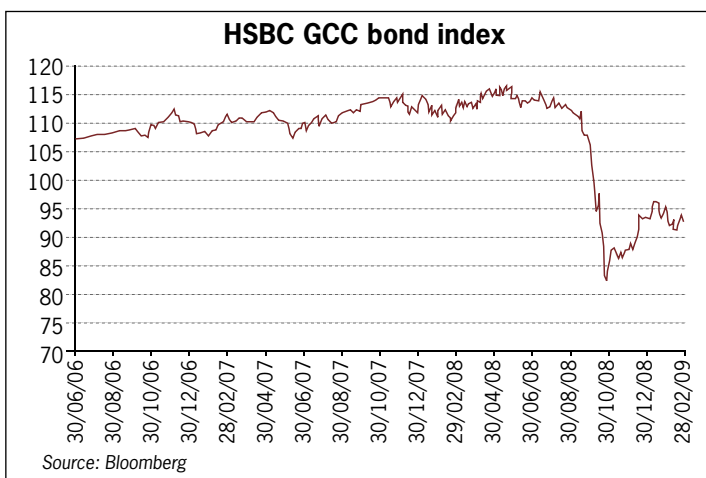
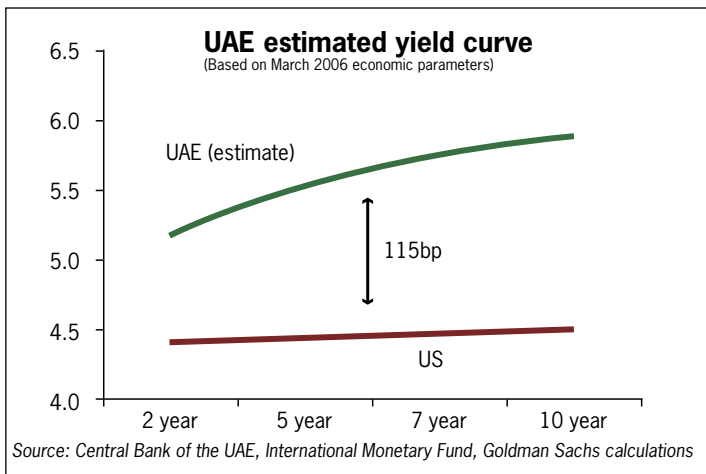
to build confidence from the authorities not only with issuances from governments, but also setting up proper regulations to this effect," Hussain says.

The authorities need to ensure supply through issuances, while demand should come from both institutions and retail customers. Today, apart from a few pension fund-type institutions in the region, there are hardly any ready and regular buyers of bonds/sukuk, Hussain points out.

Anne further emphasizes that the development has to be from both sides. "There has to be demand for such products. And at the same time, governments need to ensure an investor-friendly environment and encourage the supply of such instruments," he says.

In most developed bond markets, demand comes from pension funds, insurance companies, mutual funds, corporate treasuries and, needless to say, retail investors. In the GCC, pension funds are still relatively small and primarily equity-based. In addition, corporate treasuries normally limit their investments to time deposits. Insurance companies lack the regulation and expertise that would enable them to actively invest in these markets.

The good thing is that the meltdown has resulted in





Abdul Kadir Hussain

many retail investors looking to diversify their investments. Now the region, which hardly had any supply of fixed-income funds, is beginning to see a steady increase in its supply. This

trend is one that is expected to continue, says Popat.

“There are retail bond mutual funds in the region. In fact, we run one ourselves, and it’s just that these products are not popular with retail investors because the bond product is not very well understood by most retail investors,” notes Hussain. “The biggest thing required for retail participation is education about the value of investing in bonds and information about the bond mutual fund products available in the market.”

While it is essential that the GCC countries need a yield curve to develop a deep financial market in the region, many issues need to be addressed by the governments, including corporate governance

and a strong legal framework. Once the number of issuances grows, an index or indexes will follow. Some of that work has already begun, but much more needs to be done in terms of creating depth in the secondary market.

Today, in the GCC, it is only institutions that buy these bonds and hold them until maturity. Unless the secondary market becomes active, the volume of investors and the interest will remain low. If such a situation continues, the region will not be able to afford competing with the rest of the world for liquidity and finances in the future. As Garzarelli pointed out, a spare tyre is a must, especially when the ambition is to compete successfully globally.

## A little about bonds

A bond is like a loan. The owner of a bond gives the issuer (which can be a corporation, government or agency) a sum of money that can be used for a certain purpose. In exchange, the issuer will pay the bondholder certain interest over a period of time and eventually return the initial amount loaned. Because it is basically a loan, bonds are also known as a ‘debt security’. Since the income to be earned from the bond is fixed after a fixed tenor, it is also known as a ‘fixed income security’.

The need and usefulness of a bond market for the growth of a country’s financial market and economy requires no new introduction. Bonds are less flamboyant than stocks, but fulfil an extremely important function for the economy. For companies and states, they offer long-term financing. For investors, they are an important alternative to stocks.

Bonds serve different purposes for different entities involved – investors, the government, banks and corporates.

As the companies in any country become globally competitive, relying on bank funding over time might become scarce and expensive. Furthermore, raising equity eventually entails dilution of rights, so they need an alternative source of funding. Debt financing works as an effective alternative, and the debt equity balance usually works towards improving return on equity.

It is beneficial from a bank’s perspective as well. While tier I capital is expensive, banks need a source of tier II capital (as subordinated debts). Banks also need term debt to mismatch their typical strategy of lending long and borrowing short.

In any country, sovereign issuance usually creates a further tool for monetary policy, control

of money supply and brake on inflation.

From an investor’s point of view, asset diversification is always welcome. As bonds are often negatively correlated with the stock market – they move up when the latter moves down, and the other way around – they also play an important role in balancing the portfolios of private households and institutional investors like pension funds. For pension funds and insurance companies, it is important to match long-term liabilities with safe assets like fixed-income instruments, which are less volatile and offer a more predictable flow of income.

Moreover, in the case of equity finance, investors have to take a risk, since holders of an equity stake share in return with losses truncated to the downside. On the contrary, debt finance is risk-averse, since debt holders do not share on the upside.