



Emerging Market Focus

FIM RESEARCH

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Abu Dhabi's eleventh-hour bailout: Dubai World gets lifeline but challenges remain

Summary

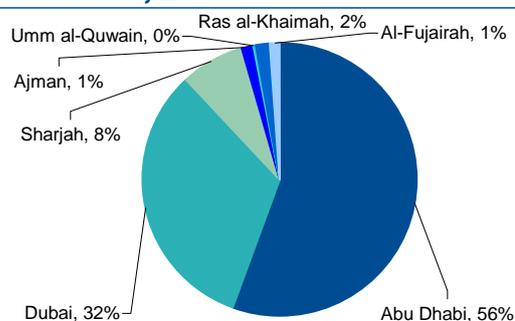
- Dubai's oil-rich neighbour Abu Dhabi has agreed to a last-minute bailout of struggling state-linked firm Dubai World involving USD10bn that will sustain it until the end of April, including payment of a USD4.1bn Islamic bond of Nakheel maturing today. With mountains of debt to be restructured by Dubai in the medium term, Abu Dhabi's bailout, while easing immediate investor worries about sovereign support for struggling Dubai companies, only scratches the surface in terms of the emirate's debt troubles. We believe Abu Dhabi has and will attach political conditions to its financial rescue, including possibly seeking strategic equity stakes in Dubai assets and reining in Dubai's independence in foreign policy, customs, as well as greater banking regulation on Dubai-based banks. The federation is the greatest beneficiary as well as Abu Dhabi, which stands out as its solid supporter.

The government of Abu Dhabi has moved again to bail out Dubai, demonstrating its commitment to strengthening the federation of the United Arab Emirates. Abu Dhabi, the wealthier capital of the UAE comprising 56% of total GDP, stepped in with a last-minute USD10bn bailout on Monday to enable its debt-laden neighbour pay off a USD4.1bn Islamic bond. Without this lifeline, we believe Dubai's debt troubles would have amounted to a crippling default, severely damaging market confidence in the UAE.

The repayment of the Nakheel bond took many investors by surprise, although Dubai's stock market had rallied in the two days prior to the announcement, indicating some investors – piling into stocks including Emaar Properties – expected an agreement would be reached. In the past two weeks, the Dubai government had withdrawn an implicit sovereign guarantee of the debts of Nakheel's parent, Dubai World, leading investors to believe the *sukuk* would not be repaid by the 14 December deadline. This prompted credit rating agencies to downgrade the debts of many Dubai state-linked companies to 'junk' status and slash ratings of banks in the emirate.

The understanding had been that Dubai World would strive to negotiate a 'standstill' agreement with banks to extend maturities of the *sukuk* and about USD22bn in other debts of the conglomerate reaching maturity in the short to medium term. The differentiation between Dubai sovereign debt and the liabilities of Dubai Inc has shaken investor confidence in the UAE and, more broadly, called into question the short-term investment case of the Gulf Arab region, including oil-rich Abu Dhabi, Saudi Arabia and Qatar.

UAE emirates by share of GDP, 2008



Source: Ministry of Economy

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In an eleventh-hour turn of events, Abu Dhabi poured USD10bn into a Dubai Financial Support Fund (DFSF) set up in February 2009 to help it pay obligations to creditors and contractors after real estate prices in Dubai sank following a six-year building boom. Little is known about the allocation strategy pursued by the DFSF, which reports to Dubai's Supreme Fiscal Committee. The Abu Dhabi money would be used to cover Dubai World's working capital commitments and repay debts due up to 30 April 2010.

Today's USD10bn marks the first funding that has come straight from the Abu Dhabi government and was provided on the condition that Dubai World achieved a standstill agreement on remaining troubled debts amounting to about USD22bn, most of which lies with Dubai real estate firms Nakheel and Limitless. Investors should be aware that the money does not constitute an outright bailout of Dubai by Abu Dhabi given the enormous amount of debt restructuring required in the coming months.

Media reports said the Abu Dhabi government had not attached any conditions to the debt, which took a different form from the USD15bn provided to Dubai earlier this year by the UAE central bank and two banks in which the Abu Dhabi government has major shareholdings. In the case of the first USD15bn, Dubai issued bonds in exchange for the funding. The language of the latest USD10bn is more fluid, using neither the term bond nor loan. "The government of Abu Dhabi has agreed to fund USD10bn to the Dubai Financial Support Fund that will be used to satisfy a series of upcoming obligations on Dubai World," the Dubai government said of the funding.

No free lunch: Abu Dhabi's political gain

There has never been doubt about Abu Dhabi's ability to provide financial support to Dubai, only its willingness to do so. The UAE capital holds more than 90% of the country's oil reserves and is the world's third-largest oil exporter. The two emirates are part of a federation of seven emirates, but each is run by a separate ruling family and they have taken different, often contrarian development paths in recent years – Dubai's involving much more leverage and risk. However, every bailout comes at a cost and Abu Dhabi is not running a philanthropic investment agency. We believe Dubai will be forced to yield some autonomy to Abu Dhabi, which is likely to be heavily involved in the restructuring of Dubai World and could seek strategic equity stakes in key assets held by Dubai.

The benefits accrued by Abu Dhabi will partially be political in nature, even if few public announcements are made. We expect the UAE federation could be a clear beneficiary, bringing into federal control such areas as customs control and foreign policy. Dubai has been following its own development path in recent years, and we expect it will move more in line with the federation in the future. The shifting balance of influence of Abu Dhabi is already visible on the ground in Dubai, with large billboards showing Dubai ruler Sheikh Mohammed alongside UAE President and Abu Dhabi ruler Sheikh Khalifa. In the past, such billboards would have depicted only the Dubai ruler.

Dubai and Abu Dhabi have reached compromises in the past. In 1979, Dubai opposed an Abu Dhabi proposal to strengthen federal ministries and reduce the autonomy of individual emirates. As a compromise for Dubai's greater integration into federal politics, the ruler of Dubai would also hold the post of UAE vice-president and prime minister from that point onward.

Greater Abu Dhabi influence over Dubai is also likely to extend into the foreign policy space, where discrepancies have existed on such crucial issues as dealing with Iran. During the 1980s Iran-Iraq war, Abu Dhabi supported Iraq while Dubai put forward a favourable pro-Iran policy. Iran is Dubai's biggest trading partner today and Iranian expatriates in Dubai number around 350,000. For a federation seeking one rather than multiple foreign policies, the Abu Dhabi aid could make Dubai more likely to heed to federal calls, including the adoption of policies towards Iran that are more in tune with its Gulf Arab neighbours. Abu Dhabi may also apply more pressure on Dubai's banking regulatory environment, which has been the target of criticism from other Gulf states as well as the US.

Smother restructuring

By extending this USD10bn, Abu Dhabi is paving the way for a smoother restructuring process for Dubai. In the coming weeks and months, Dubai World's global assets will inevitably gain better valuations, enabling the company to sell assets at more favourable rates to help pay off future debts. Already, Dubai has reduced its holding in Egyptian investment bank EFG-Hermes by 7% for a profit of USD120m and lost a stake in the New York W Hotel in a foreclosure auction. We believe Abu Dhabi will continue to support Dubai companies selectively, but not without a cost for Dubai.

By intervening at this stage, Abu Dhabi may be striving to dampen downside risks to its reputation and avoid the drastic deterioration in the quality of Dubai's asset base had the bailout not occurred. Selling assets abroad might not have been feasible and there could have been the fear that some of Dubai's assets – within the UAE and outside – might have ended up in the hands of foreigners. Concerns remain about how Dubai World will use the money and whether some of the funds will go towards supporting ill-fated foreign investments acquired on heavy leverage, such as the MGM Mirage, Casino Las Vegas or Barney's New York.

The bailout was in Abu Dhabi's interest, and we believe the UAE capital will be watching how events unfold very closely and may push its hand as to which assets stay and which go. We also believe there are non-financial conditions attached to this financial bailout. Behind the scenes, Abu Dhabi could be trying to negotiate equity stakes in some of Dubai's strategic assets, such as its Jebel Ali port (among the busiest in the region), the Dubai airport (the top regional hub connecting Asia, the Middle East and Europe) or its newly opened metro (which could provide the basis for a nationwide light rail system). Abu Dhabi may also seek to merge Dubai's prized Emirates airline with its own carrier, Etihad.

The debt repayment announcement coincided with the final deadline for Nakheel to repay its Islamic bond, the proceeds of which had been used to finance a series of lavish real estate ventures, including three man-made islands shaped as palm trees off Dubai's coastline. The Abu Dhabi move also comes as leaders of Gulf Arab countries meet in Kuwait this week for their annual summit. UAE President, Sheikh Khalifa bin Zayed al-Nahayan, would have been hard-pressed to resolve the Dubai debt problem before meeting his regional counterparts, including Saudi King Abdallah. The regional fallout of Dubai's troubles have been vast. Companies across the region have shelved bond issuances, equity markets have fallen, and investors have reacted indiscriminately towards Gulf investments.

Abu Dhabi itself has become the target of ratings reviews, with Moody's saying last week it would review UAE and Abu Dhabi government-related issuers for possible downgrades. Hence, by stepping in Abu Dhabi will ameliorate the prospects for its own state-linked issuers to tap debt markets in the coming months to finance a wide-sweeping development programme.

Credibility shaken

While the announcement does show Abu Dhabi has the financial clout and willingness to support its neighbour, Dubai's debt predicament is far from resolved by the USD10bn injection. The Dubai government and related entities, widely known as 'Dubai Inc', have upwards of USD80bn in debt, accumulated during a regional economic boom that began in 2002 with the rise in oil prices. Unlike Abu Dhabi, and other Gulf countries, only 3% of Dubai's GDP is derived from oil. The emirate relies instead on volatile revenues from real estate, financial services, retail and tourism, all of which took a substantial hit during the global financial crisis. Dubai World alone has about USD50bn in debt, and the government said this month some USD26bn of this would be subject to restructuring talks with creditors.

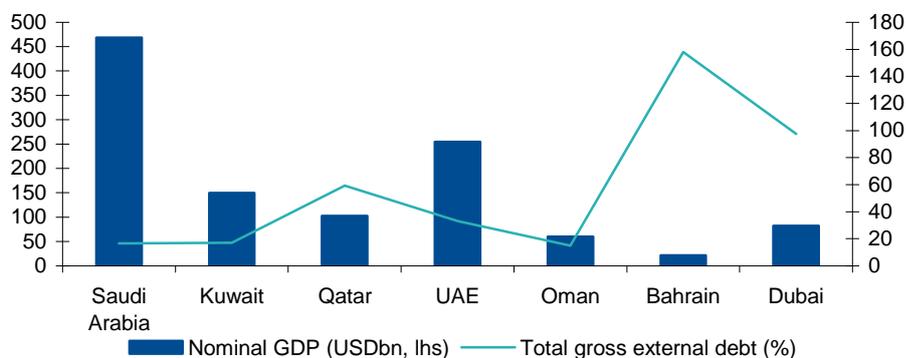
Abu Dhabi has essentially given Dubai World a lifeline, buying it time and providing it with a better platform from which it can negotiate new repayment schedules with banks. It is also likely to sell a number of its prized assets abroad to help settle some of the debts. On the ground, we anticipate downward pressure on the Dubai real estate market to continue, with commercial real estate witnessing further downward price pressures.

While strong buying and a return of risk appetite are inevitable outcomes this week on regional markets, discerning investors will continue to exert some level of caution towards Dubai, and the wider region, in the short term. The Dubai government said it was introducing a reorganisation law “based upon internationally accepted standards for transparency and creditor protection”. It said the law would be “available should Dubai World and its subsidiaries be unable to achieve an acceptable restructuring of its remaining obligations”. Any steps to boost transparency will ease investor concerns in the future.

Still, we believe that global investors will continue to remain cautious on Dubai and, gradually, their focus will turn to Gulf and other Middle East economies that are less leveraged, exhibit few excesses, possess solid revenue bases and boast strong development plans. Hydrocarbon-rich Saudi Arabia, Qatar and Abu Dhabi will have a strong marketing opportunity as Dubai, accounting for less than 8% of Gulf GDP in 2008, restructures mountains of debt. The emirate has more than USD50bn of debts reaching maturity in the next three years, and about half of this could be regarded as bad debt. The Dubai business model is clearly not viable going forward.

Oil prices around USD70/bl support Gulf economies’ fiscal profile. Growth will pick up in the region next year, although Kuwait faces downside risks from escalations of disputes between parliament and the government. However, Saudi Arabia has committed to spending USD400bn on infrastructure in five years, Qatar is set to be the MENA region’s fastest-growing economy in 2010 with 20.3% growth as it raises its natural gas output, and Abu Dhabi projects annual GDP growth of 7% per year to 2015. We maintain our view that the UAE economy will contract 3.6% this year due to both cutbacks in oil output and a slowdown in some non-oil sectors, such as construction. Growth should pick up next year to 2%, led by expansion in Abu Dhabi’s non-oil sectors and higher oil output.

Gulf Arab debt-to-GDP ratios



Source: Official data, IMF regional economic outlook, Calyon estimates on Dubai and Dubai Inc. debt

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