UAE securities rally on government debt programme

EIS Asset Management

Dubai debt issue – Strong federal response

The announcement by the Department of Finance that the UAE Central Bank will subscribe to 50% of a $20bn five year bond programme launched by the Government of Dubai is the strongest signal in a series of steps announced recently by the federal government to restore confidence in the Dubai economy.

This particular step, taken in tandem with a number of recent events in the last couple of weeks, should go a long way to allaying market fears about the ability of the Government of Dubai to manage its debt payments. In the last few days, we have also seen important statements such as:

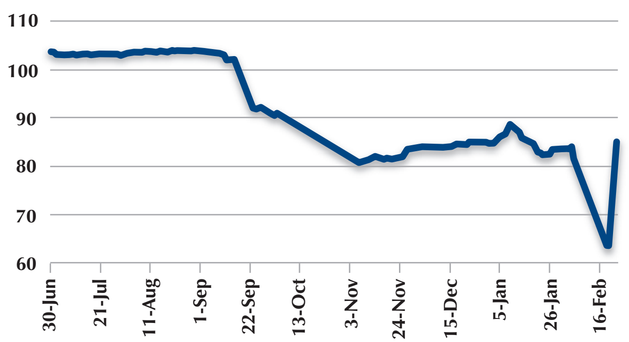
- The successful refinancing of Dubai Bourse debt repayment of $3.4bn;
- The policy decision to run a budget deficit to stoke economic growth; and
- An announcement by the UAE Finance Ministry to set up a separate bureau to manage the debt of the entire country, particularly with a view to issuing sovereign debt at a later stage

To put this development into context, the total Dubai debt repayable in 2009, excluding the already financed Dubai Bourse commitment, is around $10bn. It can therefore be clearly seen that even if the relevant corporates did not contribute anything to the debt repayment, the Central Bank commitment alone should be sufficient to cover all Government of Dubai related debt obligations for 2009.

Market reaction positive – although only back to January levels in certain issues

Unsurprisingly, the credit markets have reacted favourably to this development and the spreads on a number of Government of Dubai related entities have narrowed considerably. The chart below shows clearly the rebound in the price of the Nakheel '09 issue taking it back to prices at the end of January. The issue currently offers a yield to maturity of around 30% - a level which, in our opinion, represented good value before this news and now represents an even more compelling investment case. The major surprise for us is that the market rally was not broader – and, as we will explore, this presents an even more compelling backdrop.

Pricing levels for Nakheel 2009 sukuk



Data source: EIS, USD terms, mid price

Credit crunch – Dubai in the "eye of the storm"

Cracks began to emerge in this market in Q4 2008 as the global credit crunch intensified. Particular concerns arose over the ability of the Government of Dubai and its related entities to meet their debt servicing obligations. This resulted in the CDS spreads on Government of Dubai debt and debt issued by quasi-government entities widening considerably. These fears were further exacerbated in early February by the injection of AED16bn by Abu Dhabi into 5 major Abu Dhabi banks, as the market perceived this as a sign that backing from the federation may not be forthcoming in the event that the Government of Dubai needed assistance.

This had resulted in the spreads on Dubai sovereign 5 year CDS spiking to around 900bps in mid February, with some of Dubai Inc corporates such as Dubai Holding trading as wide as 1800 bps (from around 300bps at the end of August).

We, at Emirates Investment Services Ltd, have believed throughout this crisis that the concerns around the ability of Government of Dubai to fulfill its debt obligations have been exaggerated, resulting in lower valuations of some fundamentally sound assets.

The financial strength of the UAE and the unity of the federation underpins our confidence in Dubai's creditworthiness. In addition, given the stated goal of the UAE government to issue sovereign debt in the near future, we believe it is highly unlikely that they would allow any of its constituent emirates to default on any of their debt obligations.

These views have previously been articulated in an article in our quarterly newsletter, under the heading "Dubai: Debt servicing not likely to be an issue", written in January and published at the start of February. The conclusion of that article was that the "….Government of Dubai and the related quasi government backed issuers are extremely unlikely to default. Furthermore, we believe misplaced concerns about Dubai's credit worthiness are giving rise to very attractive investment opportunities, particularly in the sukuk market."

Other market commentators following the EIS house view

Latterly other market participants have moved to this view. Earlier this week, for example, HSBC issued trading calls over a number of Dubai government backed credits as it felt the market had become increasingly driven by technical selling rather than fundamental research. In a research report earlier this week, it said: "Based on our views as stated above, we believe that as a minimum the core Dubai Inc names will indeed be supported in the event of need, and hence we continue to believe that debt obligations of these entities will be met/refinanced as they fall due. Therefore, we regard the recent spread widening to be substantially overdone, and we believe that these credits are mispriced on the basis of sentiment and market technicals."*

The surprise? Rally was not broader

It was clear that the main areas affecting sentiment were external support for Dubai from the UAE federation and quasi-sovereign's ability to meet their near-term debt maturities. Without doubt, these two factors have been dramatically and unequivocally removed and this underpinned yesterday's movements in certain names. Perhaps the only

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surprise, given the extent of the recent sell-off was that the recovery was not stronger (and the rally not broader) than it actually was. As such, we believe there is still significant value in this space. As Sean Daykin, EIS's Head of Investment Funds, says: "Spreads should come in further over the next few weeks as we expect other announcements on banks balance sheets with the Government likely to pump more money in. Spreads are still very wide on the sukuk portfolio which doesn't seem to have really priced in this new reality yet that the UAE government has explicitly supported Dubai."

Emirates Sukuk Fund No 1 Limited

Given this view, and in line with our stated intent to launch products that could capitalise on the pricing anomalies in the market, Emirates NBD last month launched the Emirates Sukuk Fund No 1 Limited, a structure which would invest in a basket of sukuk at deeply discounted levels and which would maximize returns by seeking to hold the assets to maturity or to sell once prices returned to levels closer to "fair value".

** Source HSBC, Gulf Credit, February 2009.*

By investing into this latest EIS-managed fund, investors have the opportunity to lock in some of these high yields. Given the decisive action taken by the policymakers, a key risk has been mitigated to some extent, increasing the likelihood of price gains as these issues move towards maturity. We believe that the callable close ended structure of this fund remains an appropriate way to exploit the price distortions, locking in a high pay off at maturity, or earlier if the market were to rebound sufficiently.

The recent market events have begun to validate our investment call as strong policy response from the federal government has led to some of the extreme moves seen in recent weeks being reversed. That said, and as stated in the example of the Nakheel December 09 sukuk, we are now back only at end January levels. As such, we still believe that the sukuk market, particularly for investment grade names with an element of sovereign backing, continues to be very attractive.

Emirates Sukuk Fund No 1 Limited

Expect deposit rates to decline in line with EIBOR…

The indicative return levels of the model portfolio for the fund are even more attractive when they are compared to the expected future bank deposit rates, which we believe will decline significantly. Policymakers have already indicated that this will be the case. In a speech last week, the UAE Central Bank Governor expressed concerns at the high level of interbank interest rates and indicated that joint action will be taken by the Ministry of Finance and the Central Bank to rectify the situation. Given this background, it is reasonable to assume that we will see a decline in EIBOR. Further, we would expect the current spread of nearly 2.2% between EIBOR and LIBOR to narrow considerably. This will remove an obstacle to bank funding and mean they can reduce the above-average deposit rates which they have put out in order to attract retail funds which are traditionally the most attractive for high street lenders. Investors will be forced to look further afield for higher rates – and will no doubt head straight into short-term credit markets.

…And a portfolio shift to reflect a new risk/reward profile

Following yesterday's news, and the implicit lowering of the risk premium associated with several Dubai entities, we have reviewed the model portfolio for the Emirates Sukuk Fund No 1 Limited. At the current pricing levels our model portfolio is looking at a potential yield in excess of 15% annualized (gross weighted).

Lower risk, but the same reward?

In our view such "equity like returns for sukuk like risk" indicates that while the news last night represents a key step in arranging a macro policy response, prices still offer significant discounts to par value – in other words, a significant risk has been removed, but equally significant rewards remain for those looking to extract long-term value from regional securities markets.

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