

Client update:
Dubai World announcement – Portfolio and market implications

Background

The Dubai Government announced on 25 November 2009 that Dubai World will be seeking consent from debt holders to freeze debt repayments until at least 30 May 2010. Dubai World (“DW”) is 100% owned by the Government of Dubai. The major assets of DW are DP World (77% owned), Istithmar (100%), Nakheel (100%), Economic Zones World (100%) and several other entities. In line with DW’s later statement, certain entities will be excluded from the debt restructuring, including DP World and the Jebel Ali Free Zone.

In total, it is estimated that Dubai World has outstanding debts of \$59bn., of which approximately \$26bn. is thought to be subject to the restructuring process, and the Government of Dubai approximately \$80bn. Moody’s announced on Thursday that it will downgrade the several government aligned companies including DP World, Dubai Holdings Commercial Operations, JAFZA, DEWA, DIFCI and Emaar.

As you will see from this note, prior to this announcement, Emirates Investment Services Limited had greatly reduced its exposure at both a macro and instrument level to securities and companies affected by the announcement. In particular, we have sold down more than three-quarters of our exposure to Nakheel securities (where we have discretion or the ability to advise clients). Additionally, we closed the Emirates Sukuk Fund No 1 Limited the week preceding the announcement and clients in this fund are unaffected by the market movements caused by the Dubai World announcement.

Here we deal with the short- and long-term effects of the announcement as well as seek to highlight positions that are currently held in our public funds. This commentary is therefore reflective solely of our fiduciary duty to investors in these funds and accounts. They are not reflective of any proprietary positions. We would stress that, at the moment, the position is extremely fluid. A single announcement by Federal authorities or other types of major announcements may alter the conclusions here significantly.

Market reaction: short-term

The timing of the announcement meant that global and derivatives markets were the first to react. Credit default swap spreads moved out substantially for Dubai and Abu Dhabi and sukuk and bond prices of the affected entities moved down sharply in London trading at the end of last week. Subsequent announcements and clarifications of the positions have alleviated some initial concerns and major European bourses rose on Friday. Certain key trades reflect the mood:

- The USD/Yen moved sharply lower towards 84 but has since retraced to trade at over 86
- The USD/Euro fell toward 1.47 but is now trading at over 1.50
- European markets rose on Friday regaining about 1% of the previous day's 3% slide
- Middle Eastern markets have opened lower. At the time of writing, Abu Dhabi has been harder hit, falling 8% with Dubai down 7.1%. Interestingly, financial stocks have not been the worst affected

Immediately, there are a number of key issues to address or of which to be aware when making investment decisions. These include:

1. Clarification on the announcement as to extent of the “standstill” and whether it will actually be enforced. We are already seeing reports that certain instruments may be paid back as planned (notwithstanding the announcement) or that it will be paid back but with a “haircut”. This “noise” needs to be eliminated from the system for investors to evaluate clearly what they perceive to be fair value for individual securities.
2. Credit for Dubai institutions may be constrained for the foreseeable future. Finance may have to be raised from domestic sources for some time.
3. Investors will focus on other Dubai Government aligned institutions especially where there is a large real estate exposure.
4. The legal outfall, especially regarding the real estate development companies, may take a significant time to unwind.
5. Given the strong infrastructure of Dubai, the recovery will eventually occur but the scale of development and the rate of growth will be severely impacted. A large degree of de-leveraging will have to occur which will dampen growth prospects.

We can also expect some upward pressure on EIBOR in the coming weeks and months. Although the trend has been firmly downward through 2009, and despite the assurances from UAE Central Bank, there is likely to be a greater urgency on deposit gathering resulting in a raising of the Interbank level. This has implications for funding costs, borrowing and securities valuation.

Market reaction: medium-long term

As a number of governments have already stated, this is not an issue which should pose systemic risk to global institutions, especially given the UAE Central Bank's decision to state publicly that it stands behind lenders in the country. This has been well received. “This is a timely pre-emptive move from the central bank,” Ahmet Akarli, an economist at Goldman Sachs Group Inc. in London said in a note to investors that was cited on Bloomberg. The central bank is “ensuring that local markets are operational” and banks “have access to ample liquidity.”

Moreover, there is little doubt that a restructuring of certain organizations – and the transparency that, by necessity, comes with it – is a positive thing long-term for the markets. There are clear precedents for these types of events in emerging economies and, in time, these same economies coming through much stronger in the long-term. Lovers of the BRIC story will not possibly remember (or want to be reminded of) currency and debt crises of “B” and “R”, with the latter (along with global hedge funds) posing a much greater threat to the world’s economic system than Dubai World’s announcement. The key is handling the transition from managing the short-term problems created by the announcement to restructuring and then creating a framework once more to attract long-term sustainable investment in the region. Inevitably, this will take time to work through and asset prices will undoubtedly be affected in the near term. However, this type of market dislocation normally affords a number of opportunities and we will be seeking to bring these to clients in the coming weeks and months.

Portfolio and account management

1. Following recent rallies in a wide range of securities, especially regional fixed income and sukuk, we have reduced our public funds and segregated account fixed income portfolio exposures to the Dubai companies significantly over the past few weeks. Prior to this announcement we had sold approximately 75% of these instruments. Direct exposure to Nakheel securities was reduced by about 95%. This has helped insulate client portfolios and funds.
2. All segregated account clients holding Nakheel 09s were sold, or advised to be sold, earlier in the quarter.
3. Any further sale action needs to be considered against the prevailing prices. We may see significant selling pressures in the next few local trading days and should not participate in panic selling activities.
4. We believe that significant opportunities may also arise in the weeks ahead and would focus on investments in companies with viable business models and strong balance sheets and that are not dependent on governmental support for survival.
5. In terms of equity exposure we hold no exposure to directly affected companies. However, as the markets in general are expected to be impacted, the exposure to DFM/DIFX listed companies of 10% in Mena Top Companies, 16% in Mena Opportunities and approximately 10% in Mena High Income will cause a fall in the share price.
6. The Emirates Sukuk Fund No 1 Limited which was launched in February 2009 and which had delivered strong positive returns to clients was closed the week preceding the announcement and clients invested in this fund are therefore unaffected by this announcement.

Investment opportunities

While we are pleased we have been able to safeguard client assets, as far as is reasonably practicable, there will inevitably be wider market reaction caused by the Dubai World announcement. We expect a sell-off, possibly indiscriminate, in regional fixed income and will be looking to take advantage of this with trades for advisory clients as well as the application of new products specifically tailored for this event. We will communicate this to clients in the near future once we have studied in detail the markets and securities that we follow. However, the extent of the markdown is already apparent in the credit markets. Below shows the price movement of certain instruments before and after the announcement:

- Nakheel 09: 55c (-49.70%)
- JAFZA 12: 60c (-40.58%)
- RAKIA 12: 80c (-19.88%)
- DP World 17: 75c (-23.17%)
- DIFC 12: 60c (-38.07%)

The scale of these moves, in such a short space of time is unprecedented. While some movement was of course expected the fallout can already be seen to have pushed yields to record levels, beyond even those seen in February 2009.

Within our public funds, we are comfortable with the relatively limited exposure to UAE equity markets.

Conclusion

While this event is not a new phenomenon, it is the first time that the problems caused by the recent credit crisis have been felt so severely in the Middle East. We recognize the short-term dislocation that will arise in securities market but, having sold strongly into the recent rally, are comfortable with actions taken and the relatively low level of exposure to affected names and markets across our portfolios and accounts. We believe that some recent “hot money” into these markets, in the form predominantly of hedge funds, may leave quickly which will push local markets (which have already lagged global emerging markets) to attractive levels. Should this occur, as we recommended earlier in the year, there may be selective opportunities for above-average returns.

We recognize that there will be some significant short-term issues to overcome: for example funding costs and mark to market losses should the instruments continue to trade at distressed levels. However, history shows that these levels, especially when securities not directly related are marked down, do not persist for long and may represent opportunities as early as Q1 2010.

Finally, we expect that Dubai will eventually emerge from the painful adjustment period – and in a much stronger position to resume the growth path as dictated by the long-term strategic plan.

Emirates Investment Services Limited
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