Dubai – implications of restructure

December 2009 - Author: Daniel Wood, Fund Manager

Dubai has recently announced that state owned holding company Dubai World is to restructure $26 billion of its outstanding debt liabilities. Given the timing and the level of market surprise, there are potentially further ramifications for many related and non-related parties. The fallout following this event has already been felt in the portfolio valuations of investment managers across the globe, but what are the wider implications for investors, Dubai, the region and emerging markets generally?

Investors

It was obvious to investors that Dubai's real estate developer Nakheel, a subsidiary of Dubai World, would be unable to sustain its onerous debt burden without external assistance. Its problems were high profile and well documented. The property market in Dubai had collapsed, consultancy fees remain unpaid and they were struggling to secure pre-construction sales on unfinished projects. Reading through their prospectus, it was also clear that recourse to sovereign assets was assumed, but not assured. Yet with the maturity of its $3.5 billion bond just two weeks away, investors were pricing the issue at par.

It is always easy to be wise after the event. However, long-held and complacent assumptions regarding sovereign support for quasi-sovereign bonds have already been challenged and subsequently ignored several times this year. Similar cases in Ukraine and Kazakhstan should have added to an 'investor beware' mentality, but these were seemingly dismissed by the market as idiosyncratic country risks.

The message to investors from the restructure of Dubai World's debt is likely to be that it is important to price in the probability of parent/sovereign support more realistically. Invariably there will be doubt as to the level of support and investors will have to be more readily willing to analyse the debt sustainability of a quasi-government entity on a stand-alone basis.

Dubai and the Middle East

The widely held perception that Abu Dhabi stood behind all of Dubai's debt has now been exposed as an illusion. The deafening silence from the oil rich emirate is further alarming the market. Additionally, we have yet to establish exactly why Dubai World is planning to restructure its liabilities. The financial cost to the region of restructure is ultimately likely to be higher than continuing to service the debt. Certainly at a sovereign level this appears more an issue of willingness rather than ability to pay.

Has Dubai's unrelenting credit fuelled expansion finally snapped the patience of Abu Dhabi's financiers, or was this default initiated by Dubai looking for an opportunity to establish greater independence? Less realistic, but also grabbing headlines, is the potential that the unknown off-sheet liabilities of Dubai are actually much higher than the market perceives and default is the only viable option.

CAUTION: The opinions expressed in this document are the views of Rexiter Capital Management Limited.
This document is intended for institutional investors only and is not suitable for retail clients.

What we do know is that Abu Dhabi banks purchased a $5 billion sovereign bond issued by Dubai just hours before the default was made public. This sent a strong message to the market that the financial link between the two emirates was assured. Ironically, this $5 billion issue was a tranche of a planned $20 billion sovereign issue from Dubai that was to be transferred to the Dubai Financial Support Fund, which in turn is to be used to financially support struggling government-linked companies.

Subsequently however, the government have been on record as stating that this fund was not directly linked to the restructure of Dubai World and it appears unlikely to be used to fund the payment of the Nakheel bond maturing on December 14th. Dubai has also gone on record as saying that the emirate is not the same entity as Dubai World and that creditors should take more responsibility for their investment decisions. This is potentially an ominous pre-cursor to an announcement of low recovery values for investors.

Information has been drip-fed slowly so far, but the treatment of debt holders by Dubai will be crucial in establishing how the emirate will be viewed by investors going forward. It is expected that foreign investors, of which the UK rank highly, will be treated equably in comparison to locals, but this is not yet cast in stone.

What is clear is that with the safety net provided by Abu Dhabi seemingly removed, the property market collapsing and larger write-downs looming, raising capital in the future in Dubai could be problematic. To be able to persuade investors that the emirate remains an attractive investment destination, Dubai will have to offer much higher incentives. Loosely worded disclaimers and complex ownership structures will no longer be tolerated.

The government owned utility Dubai Electricity and Water Authority yesterday announced plans to sell $2 billion worth of bonds in the first quarter of 2010 to finance expansion. How the market perceives this issue is likely to be a function of how Dubai resolves its current debt issues. In terms of reputation, the Dubai World default is already very bad for the sovereign particularly if it is perceived to be politically rather than financially motivated.

Elsewhere in the Middle East the implications of the default are less severe. Although credit default spreads on Abu Dhabi and Qatar sovereign debt initially widened quite significantly, they have now justifiably returned close to previous levels. The sovereign balance sheets of these countries remain strong, both enjoy an extremely low cost basis for oil production and both have accumulated strong external reserve levels and very high current account and fiscal surpluses. There is no reason as to why the Dubai restructure should cause a domino effect in the region. Any sovereign issuance is predominantly to provide corporates with a yield curve from which to price their debt. In the case of Abu Dhabi, it could be argued that the balance sheet is even stronger and its ability to service debt increase if Dubai's liabilities are removed.

Global Emerging Markets

Historically, a sovereign default that could potentially be the largest since Argentina's in 2001, would have implications for the cost of borrowing throughout emerging markets. However, emerging markets have been severely stress tested and survived the global crisis largely unscathed, so it's unsurprising that the JP Morgan Emerging Market Bond Index spreads have hardly moved on the news of the Dubai crisis. This is further evidence of the resilience of emerging markets following positive structural changes that have occurred over the past decade.

We also believe there is little chance that this will affect systemic global risk appetite. It is unlikely that the scale is large enough to stall the global recovery, although it may mean that western banks with direct exposure to Dubai's debt that have not adequately provisioned will once again need government encouragement to commence lending. If anything, events in the Middle East over the past week will act as another reminder to policy makers that the credit crisis has not yet been fully averted and will encourage them to maintain, or perhaps even increase, current liquidity provisions. This is an environment that will continue to benefit emerging market asset prices.

CAUTION: The opinions expressed in this document are the views of Rexiter Capital Management Limited.
This document is intended for institutional investors only and is not suitable for retail clients.

Certainly there is little if any direct ownership of Dubai debt across emerging market nations and scant reason for a wide ranging sell-off. At the margin, a slowdown in investment in Dubai will put pressure on the remittances of emerging market nations whose residents work on construction projects in the Middle East. Of course, this is not to say that all emerging market assets will enjoy attractive returns over the next twelve months. The Dubai default will remind investors, who might have become a little complacent, that risks remain and 2010 is likely to see greater differentiation in performance between stronger and weaker sovereign credits.

One asset class that is likely to attract greater scrutiny as a result of the restructure is quasi-sovereign debt. It is widely thought that as a key generator of state revenue, Brazil would be unlikely to allow Petrobras to default on its debt should the company run into financial trouble. A similar assumption can be made for Pemex in Mexico, Gazprom in Russia and a whole host of other state owned entities across the emerging world. However, greater transparency will be required by investors in terms of sovereign guarantees and if they are not readily forthcoming, key public-owned sectors in the emerging market universe could find their cost of borrowing on the international capital markets greatly increased.

We believe over the longer term the implications of this restructure are positive as it brings to light another example of unsustainable financial wizardry built on very shaky foundations. If another global crisis of the magnitude we have seen over the past year is to be avoided, it is paramount that a global system that encourages sensible risk-adjusted borrowing and lending practice is in place. This latest news moves us one step closer to that ultimate position.

CAUTION: The opinions expressed in this document are the views of Rexiter Capital Management Limited.
This document is intended for institutional investors only and is not suitable for retail clients.