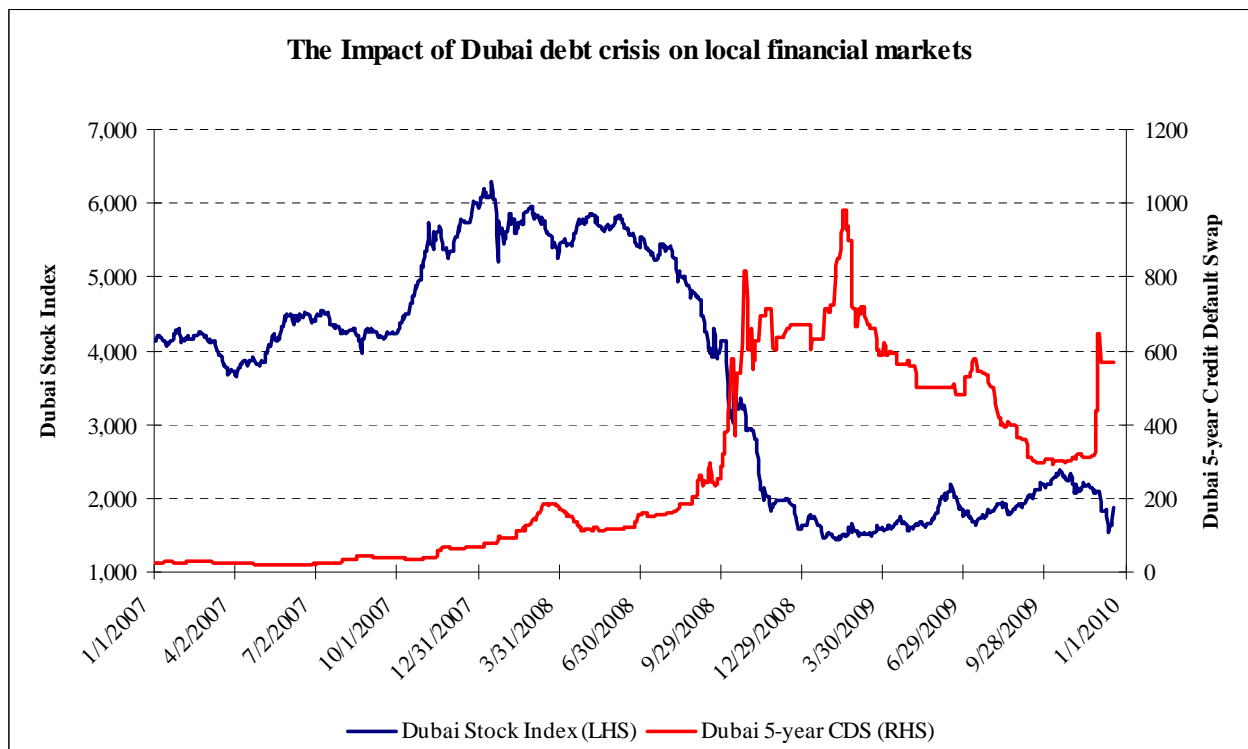


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Dubai Debacle Shows that the World Remains a Long Way from “Normal”

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Dubai, which pundits have dubbed the “world’s biggest construction project,” shocked the financial world when one of its commercial arms Dubai World announced on November 25, 2009 that it was seeking a six-month standstill on its debt and shortly thereafter announced it was seeking to restructure its \$26 billion in debt. The announcements raised doubts on the ability or willingness by Dubai to support its troubled “quasi-sovereign” corporate entities. Credit rating agencies reassessed its sovereign support assumptions on Dubai’s corporate entities and those with weak or no explicit links to the sovereign were downgraded to junk. As a result, prices of publicly-traded securities from the UAE, including Abu Dhabi, were sharply impacted. The Nakheel sukuk dropped by 60%, Dubai’s credit default swap rose over 300bps to 647bps, and Dubai’s stock market index plunged 26.7% in the aftermath. Then, in a remarkable turnabout, the government of fellow emirate Abu Dhabi unexpectedly provided financial aid to Dubai for honoring the \$4.1 billion Nakheel sukuk maturity due on December 14. Abu Dhabi provided \$10 billion to the Dubai Financial Support Fund (DFSF), an entity recently created by Dubai to assist its troubled quasi-sovereign entities. The Nakheel sukuk, which was guaranteed by Dubai World, was one of the most visible and largest amounts due by a Dubai quasi-sovereign and thus proved a crucial test of sovereign support.



Dubai and its development model is another casualty of the bursting of the global credit bubble. The emirate created and sponsored various corporate entities to develop a very ambitious development plan that included the world’s largest skyscrapers, a skiing park, and man-made islands. Much of this plan was funded with debt under very optimistic financial and economic assumptions. Unlike its neighbor emirate Abu Dhabi, Dubai does not own substantial oil reserves and thus depended on debt financing to pursue its development goals. Dubai and its corporate entities accumulated an estimated \$118 billion in debt as of December 15, or 153% of GDP, one of the highest indebtedness rates in the world. Most of the debt was issued by quasi-sovereign entities such as Dubai Holding, Dubai World, and Investment Corporation of Dubai, which together held \$90 billion.

Fortunately for Dubai, it is an elemental part of the United Arab Emirates (UAE), which has intervened to stabilize the financial sector and prevent spill-over effects. The UAE Central Bank and Abu Dhabi have contributed \$10 billion and \$15 billion, respectively in 2009, to the DFSF. Abu Dhabi is the largest of the seven emirates that formed the United Arab Emirates in 1971 and has more than 90 percent of its oil reserves, the world's sixth largest, and oil accounted for 70% of GDP growth in 2008. Abu Dhabi is also the country's center of political, industrial, and cultural activities and largest holder of oil reserves, and its sovereign wealth fund is in excess of US\$625 billion. The UAE is among the strongest sovereign issuers in the world, with a Fiscal Surplus averaging 24.2% of GDP and a Current Account Surplus averaging 18.5% of GDP in the past four years, resulting in ratings by S&P and Moody's of AA and Aa2, respectively.

The Dubai debt problem has exposed the weaknesses of the sukuk structure as a financing instrument and the UAE judicial regime. Sukuk are funding instruments that comply with the ethical investment principles of Islam, primarily the prohibitions on interest. Sukuk attempt to replicate a conventional bond by giving investors an indirect share of a tangible cash-generating asset. In the specific case of Nakheel, the sukuk are supported by different parcels of land on which rents are paid. However, the financing does not have a direct pledge of the assets, raising questions of what would happen if there were to be a liquidation. Further, neither Dubai nor the UAE have an established judicial procedure for a business reorganization and the legal system is outdated, unpredictable and lacking transparency. However, Dubai has just announced it will be introducing a new bankruptcy code. The new regulation will initially include a tribunal panel to adjudicate on potential claims against Dubai World arising from its debt restructuring. In the coming months, it will incorporate key elements of the U.K and U.S. bankruptcy regimes, such as automatic stay or moratorium for debtors, the ability to raise priority financing during the course of reorganization, and the ability to implement a restructuring supported by certain classes of creditors.



In conclusion, a default by the UAE (at the federal level) or by any of its members (the individual emirates including Dubai) is highly unlikely, unless oil prices were to fall below US\$25 per barrel for an extended period of time. The fiscal strength of the federal sovereign, and its explicit policy priority of guaranteeing its financial stability, makes default a complete anathema to the continuity of the UAE as an ongoing federation. However, corporate arrears and restructurings are not precluded despite the strength of the sovereign, and a policy of limiting the number of bailouts is necessary to protect the integrity of the sovereign credit. Support for particular semi-public corporates will likely be limited to quasi-sovereign entities whose restructuring would have a negative spillover impact on the banking system leading to systemic contagion.