The UAE Economy at a crossroad

A Report by Daman Investments, August 2010

DAMAN INVESTMENTS psc
P.O. Box 9436
Suite 600, 6th floor,
Dubai World Trade Centre
Sheikh Zayed Road
Dubai, United Arab Emirates

Telephone : +971 4 332 4140
Fax : +971 4 332 4240
Asset Mgt Div: +971 4 408 0333
E-mail : assets@daman.ae

For more information please visit
www.daman.ae

Executive Summary

Two years into the global economic crisis one thing is crystal clear: The opinion that the crisis will be over in 24 months and that it will be business as usual after that has proven to be highly optimistic. The reality is that tough economic times are with us for a while and that nations need to factor in a new set of realities in order to have a more realistic view of the environment in which they operate. The UAE is no exception to this new reality.

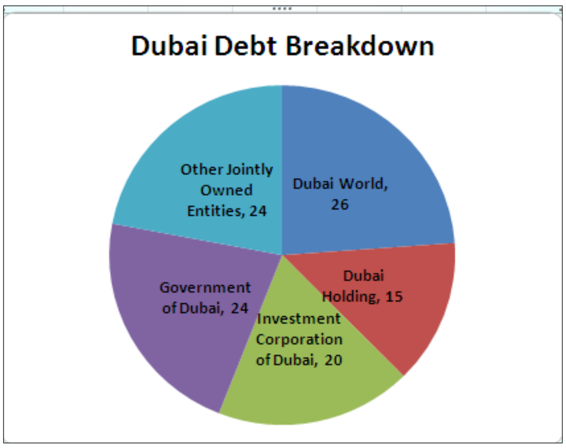
The UAE economy is presently at a crossroads that will prove critical to the manner and speed in which it emerges from its present malaise. There are tough factors to consider, and tough decisions to be made. While the economic miracle that is the UAE is far from dead, the very real economic crisis in which the country finds itself has thrust upon it a set of challenges that will require courage and ingenuity to overcome.

This brief report highlights the set of factors that impact the UAE economy today, and suggests some solutions that may help guide the country as it finds its path back to economic recovery.

The Dubai Debt Factor

Whether justified or not, the UAE as a whole continues to be afflicted by the woes of the Dubai debt situation. This situation is unparalleled in its size and severity, and has attracted global attention and notoriety for the country as a whole.

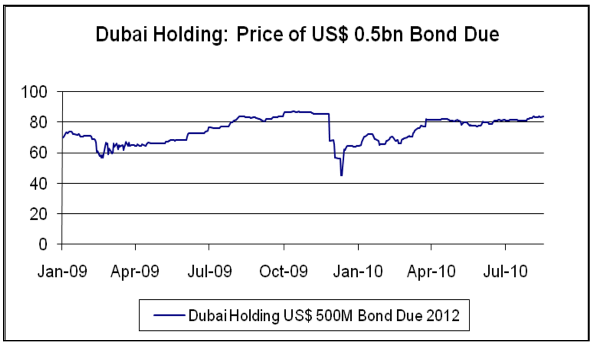
A quick recap as estimated by the International Monetary Fund circa. US$109bn of Dubai Inc debt is distributed as follows:-



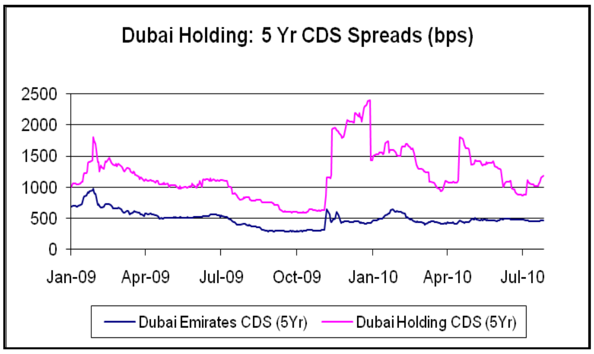
Source: The International Monetary Fund

Dubai debt woes transcend Dubai World

At the end of May 2010, Dubai World announced its final debt restructuring for the remaining US$14.4bn of debt, the terms of which have been accepted by the 7 main creditor banks and the remaining 70 were given the same terms at an informal presentation in July and Dubai World is confident that they will complete the restructuring in the coming months. The important point to note is that local banks will not have to mark to market their loans and will thus accept lower yielding advancements (pressuring the Net Interest Margins) for longer maturity.



Source: Bloomberg



Source: Bloomberg

Dubai not able to access reasonable price debt

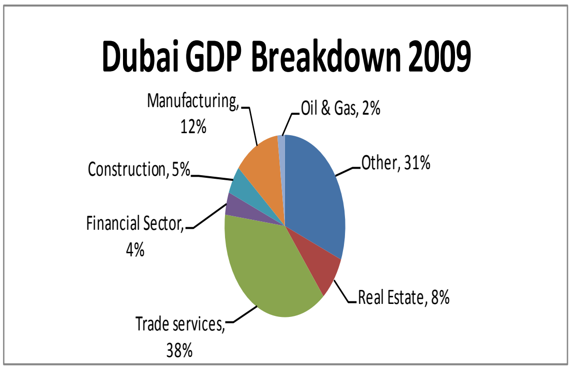
As a result, Dubai has not been able to easily access the market for debt issuance this year. Government owned entities, such as DEWA, have been able to tap the debt market as they have strong cash flow generating businesses and good transparency, albeit at a far higher funding rate. For example, DEWA's recently issued (April 2010) 5 year US$1bn bond was priced to yield 8.5%, far higher than previous years. The Dubai government has 8 bonds outstanding with maturities concentrated in the years of 2013 & 2014. Adding to Dubai's difficulties is the informal nature of the input and cooperation seen from both Abu Dhabi and the UAE Federal Government, whereby the lack of a formalized structure has led to investors speculating as to how much and when any support would be forthcoming.

Abu Dhabi debt unfairly tainted by association

Beyond Dubai, Abu Dhabi boasts a prime credit profile (Moody's Aa2 & AA by S&P & Fitch). The Emirate currently has a GMTN program of circa. US$10bn in sovereign bonds, designed to tap the market at benchmark sizes & at medium term maturities. The emirate issued two bonds in April'09 for US$3bn, the first US$1.5bn maturing in 2014 & the second US$1.5bn maturing in 2019. However, Abu Dhabi has been tainted by association as is evident by the pricing of the Abu Dhabi CDS versus their GCC counterparts. Abu Dhabi Government 5 Year USD CDS is currently priced at 107.9 compared to Saudi Arabia's 72.8 and Qatar's 90.2.

Investors need clarity on Dubai debt repayment plans whatever it ends up looking like. That will be a defining moment for the UAE economy as a whole. The inability thus far to reach this milestone has deepened the "bad credit" profile of the UAE, and has stifled economic activity and growth prospects for the country as a whole, in many cases without justification.

Let's look first at the Emirate of Dubai's GDP breakdown. (Daman Estimates)

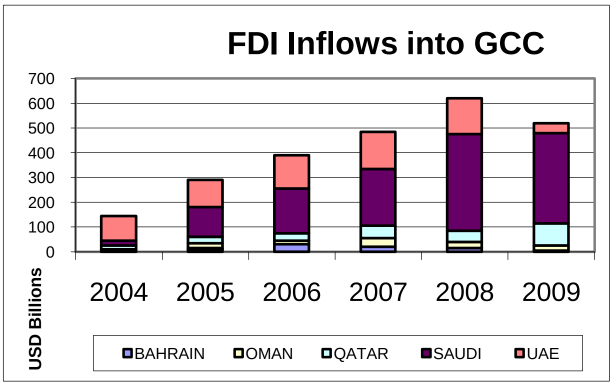


Source: Daman Estimates

In the Gulf, Dubai is the most diversified economy as evidenced by its GDP breakup. There is no individual sector that accounts for the lion share of the economy. However, if we delve deeper we find that real estate and the related construction sector account for circa. 13% both of which remain mired in the midst of a severe correction. Hence, the question one has to ask is can the rest of the sectors compensate for the drag created by the above mentioned sectors. Trade services account for circa. 38%, here given the current uncertainty of global growth it is plausible to assume that exports will see sizeable shrinkage in the current year, should global growth taper off. While Dubai will continue to play the lead role as a center of commerce in the region, the immediate future is not conducive to the levels of growth that this entrepôt of trade has seen historically.

Modest growth expectations seen on the horizon

The FDI Factor



Source: Consensus

The UAE saw the biggest contraction within the GCC of foreign direct investment (FDI) where the value of FDI slumped 72% to $40bn in 2009, whereas the GCC's FDI fell 16% to $520Bn in 2009.

FDI will only return to a friendlier UAE market

Anemic growth, liquidity concerns, a highly-publicized real estate crash, high borrowing rates and slower government development activities have all contributed to this sharp drop in FDI activity.

Going forwards we don't expect an immediate return to active FDI participation in the UAE's economy until we have a more FDI friendly environment.

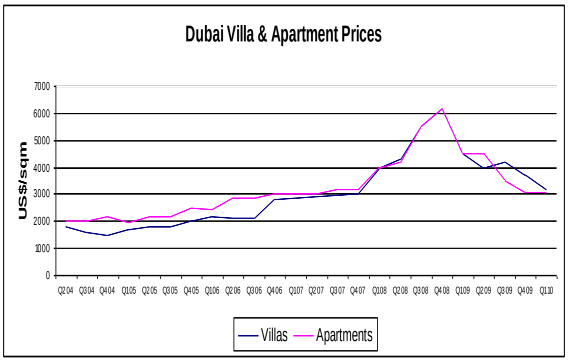
The Real Estate Factor

Real Estate Sector in Dubai to remain in a quagmire until year end 2011

Much has been written about the real estate bubble that burst in Dubai and splattered all over the UAE. Looking ahead, the story is all about what happens to this vital sector as the sector regains its balance and a new normalcy sets in.

As indicated by landmark advisory's recent quarterly report which focuses on developer ranking in Dubai and Abu Dhabi. The currently developed supply of real estate was built by master developers and hence the quality of which will be far superior than to the supply coming on stream. The bulk of forthcoming supply is being built by single asset developers who are having to downsize from their original plans. Hence, active government monitoring will be required.

We expect the real estate sector in Dubai to remain in a quagmire until at least year end 2011. Prices are now back to circa. 2006 levels, which effectively only erases the unfounded exaggerations of the market peak but does not reduce prices to levels where value is evident once again to buyers who will spur activity.



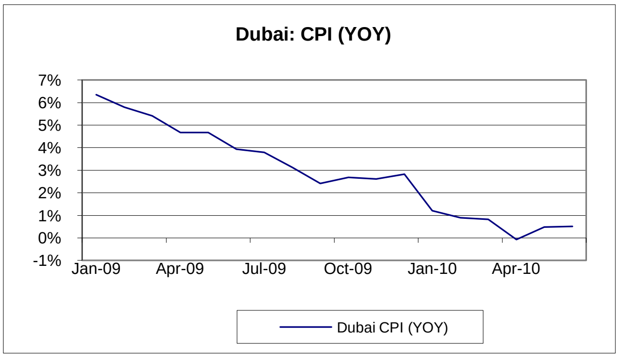
Source: Jones Lang La Salle report

There is an immediate glut within the Dubai office space. An additional 12m sq ft of office space is scheduled to be released over 2011 / 2012. City wide vacancies rates stand at around 38% and are expected to exceed 50% over the next few years with the new supply entering; however there is still a shortage of good quality supply especially in the CBD areas as evidenced by lower vacancies. Average rent has decreased around 38% over a one year period and 45-60% since peaking in 2008.

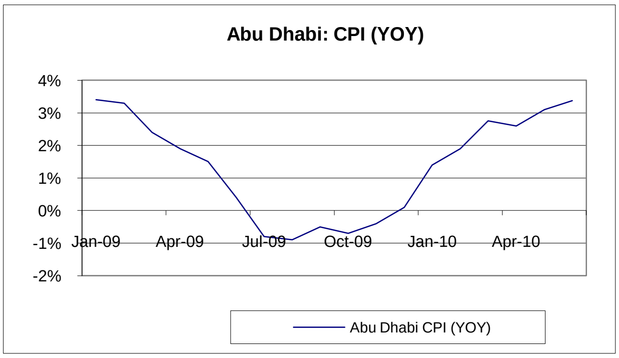
On the residential front, 26,000 units are expected to be completed in 2010 and another 25,000 units in 2011. Average apartment rents have decreased 10% Y/Y and villa rents have fallen 23% Y/Y. Over supply is still forecasted, with prices not recovering before 2011 at the earliest, hence, we expect further downward pressure on yields.

Real Estate Sector in transformative phase

In essence the real estate sector is in a transformative phase as it shifts from a period of asset and value creation to that of asset management and value enhancement.



Source: Bloomberg



Source: Statistics Center Abu Dhabi

Office vacancies to exceed 50% next few years

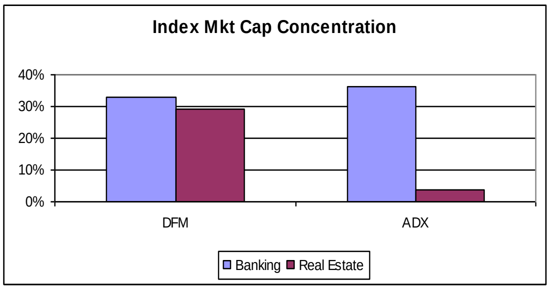
A lone bright spark as a result of the supply is the fact that the inflation outlook remains sanguine. As the major component of the UAE CPI remains housing, the outlook of which therefore remains benign. Abu Dhabi CPI remains at a significantly higher level than that of Dubai at present, however this will change as significant real estate supply is slated to come on stream this year.

The Liquidity Paradox Factor

Depending on how one views the liquidity situation in the UAE it is both abundant & low at the same time. For example, at the macro country level the UAE is a net external creditor. As specified in a recent IMF paper – this position is overwhelmingly influenced by Abu Dhabi. The report specifies that the International Investment Position (IIP) of the UAE for 2009 stands at $437 billion (Dh1.6 trillion) in assets and $132bn in liabilities that leads in a net positive position of $305bn, or 132 per cent of gross domestic product.

However, from a micro perspective there is a clear liquidity crunch, as evidenced by the funding gap faced by the banking sector (see next section). Which is having to pay exorbitant levels of interest as is evident by increasing Eibor rates, which are amongst the highest rates in the world for a US dollar pegged currency. This is as a result of the above mentioned liquidity not finding its way into the general economy & is thereby having a stifling effect on endogenous growth. There is a real need for government to start channeling liquidity into the domestic market in a deliberate and targeted manner. To illustrate, let us look at the UAE banking Sector.

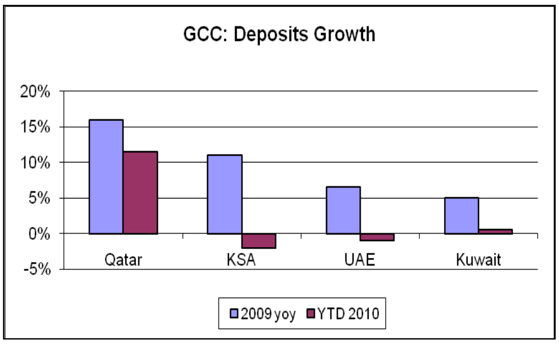
The UAE can be seen as a reflationary trade, as the banking sector accounts for over 30% of both the DFM & the ADX.



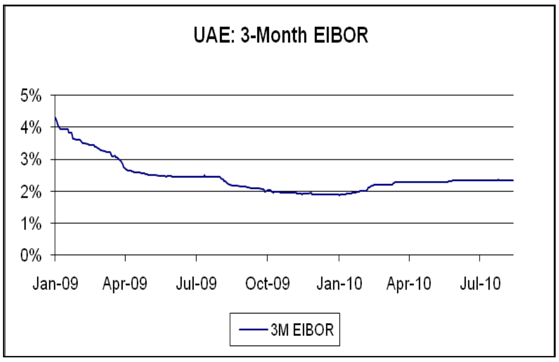
Source: Bloomberg

Hence, the banking sector is one of the main drivers of stock market performance. Given the current low interest rates banks have to cope with lower margins and increasingly higher credit costs. Deposit growth for UAE banks continues to remain in negative territory.

Given the stretched balance sheets (current funding gap is at AED 40bn) and the fact that money supply growth has been falling, any future growth will come at a higher cost of funding.

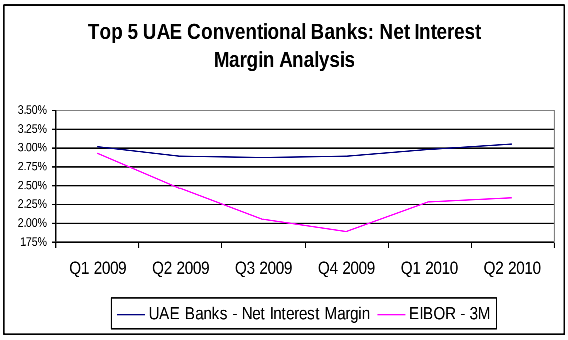


Source: Various Central Bank Data

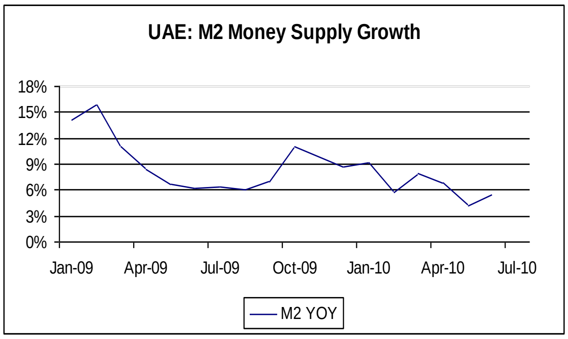


Source: Bloomberg

This is forcing banks to increasingly rely on interbank funding thereby forcing up the Eibor rates. The net impact of which is to put pressure on the banks' Net Interest Margins.



Source: Bloomberg



Source: Bloomberg

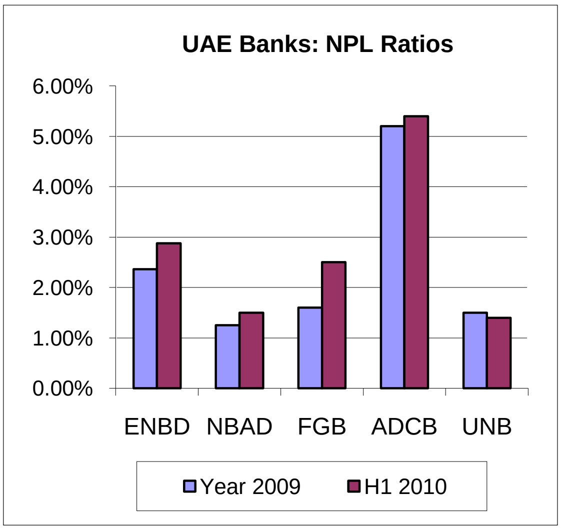
UAE liquidity position both abundant and low at the same time

Weak deposit growth leads to increasing Eibor rates

UAE reflationary trade given prominence of banking sector

Future lending growth to come at a higher cost

In addition to the Dubai Inc woes UAE banks also have to deal with private sector difficulties, such as the much publicized Saad & Al Gosaibi defaults, all of which lead us to believe that NPLs have still not peaked.



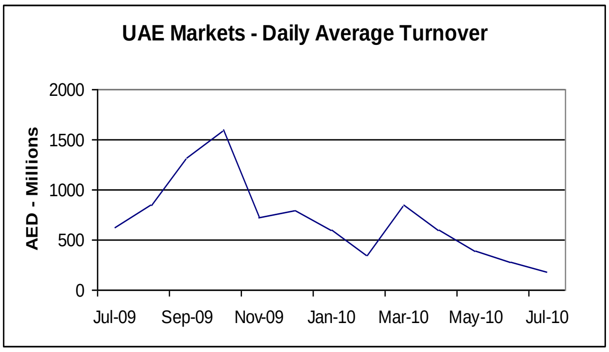
Source: Company Reports

Capital Markets Factors

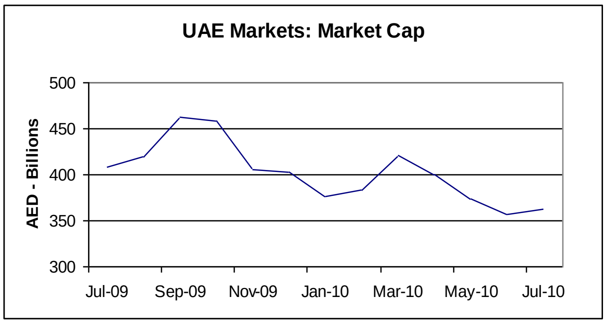
Scarcely a day seems to pass without some brokerage either closing down or suspending their market activities due to illiquidity. According to ESCA, the total number of brokers in the UAE is now down to 70 from a peak of 120 houses in 2008.

Turnover and trading volumes on the DFM and ADX have slumped, extending a trend that started as the global financial crisis struck in 2008. UAE daily average turnover is AED 445 million this year, down from AED 978 million in 2009.

Given the lack of positive news flow in the region, market participants can be seen following international trends, leading to high correlation and sensitivity to the international markets. However, we would expect significant de-correlation to occur on positive local catalysts for our markets.



Source: Bloomberg



Source: Bloomberg

Fundamental catalysts: have proven to be few and far between as evident by the recent Q2 numbers where most blue chip company earnings came below analyst estimates. On average, Q2 profits fell 17% when compared to Q1 2010 and fell 10% when compared with the Q2 2009.

The common perception that local markets are correlated to the price of oil holds untrue as the following matrix proves. The point being that our markets are more correlated on the downside as opposed to the upside which is reflected in the correlation coefficients with international markets.

Correlation Matrix

Security	CLA	INDU	SX5P	MXAP	MXGCC
ESMIND	0.23	0.77	0.81	0.74	0.83

As of Q2 June 2010

Bloomberg Ticker	Description
ESMIND	Emirates Securities & Commodities Index
CLA	WTI Crude Future Sep10
INDU	Dow Jones Industrial Average Index
SX5P	STOXX Europe 50 Index
MXAP	MSCI Asia Pacific Index
MXGCC	MSCI GCC Index

Liquidity critically low in equities markets

Number of brokerage companies shrinking

So what can be done to restore confidence?

1. The pressing need of the hour is to get clarity on the Dubai Inc debt situation. At present there are a number of estimates circulating as to the actual size of Dubai inc debt, in the body of this report we have cited the most credible – IMF at US$109bn. However, estimates vary from US$85bn – 160bn. More importantly, there is need of a coherent strategy to be articulated from the government as to how it intends to deal with this situation, no matter how bitter the pill.

2. The New Real Estate paradigm. As noted in this paper the real estate sector is going through a transformative phase from one of asset creation to that of asset management, the emphasis will be on income producing assets as the regional industry takes a long term view on property. The wrenching correction in the real estate market is leading to a new focus amongst developers by catering to the needs of end users in the middle segment of the UAE real estate sector. The key will be to deal with this process in an expeditious manner. A major milestone will be in the proliferation of dedicated real estate funds, REITS and the like focusing on the UAE.

3. Focus on core competency. Historically it has been the trade & hydrocarbon sectors that had been at the heart of the UAE's success. During the giddy years of real estate / construction fuelled growth, the focus had shifted. The UAE needs to go back to basics and refocus on these sectors, by building new trade partnerships and rekindling old ones. What will be needed is a healthy collaboration between both the public and private sphere to engender such relationships.

4. More structured initiatives. Currently, the bulk of commerce is controlled by the private sector but it is heavily skewed towards certain sectors. For example, 70% of all businesses within Dubai are involved in trade & retail industries. The government should promote the development of small business enterprises in other sectors with the use of major incentives and government assistance.

5. Cut back red tape. As noted in a World Bank finding it takes approximately 62 days to start up a business in the UAE, this is reflected in the UAE's poor ranking in the ease of doing business index published by the World Bank.

6. Channel government liquidity directly into the markets. At present Sovereign Wealth funds do not directly participate in the markets, but rather own large stakes in listed companies. If they were to come into the market this would send a positive signal to market participants. For example, a recent precedent set by the Kuwait Investment Authority, was to launch a number of funds with local managers, whereby having KIA as a co investor gave confidence to investors in the market as well as other investors in the funds.

7. The setting up of secondary pension fund providers. The absence of secondary fund providers in both the UAE and the GCC is a glaring anomaly when compared to more developed markets. This may be due to the fact that, with the exception of the Kingdom of Saudi Arabia (where locals a/c for circa. 70% of the population), the bulk of the populations within the GCC are made up of expatriates which tend to be transient by their very nature. Also the local population is entitled to a well funded government pension scheme, obviating the need for a private pension.

8. The creation of new liquidity through the introduction of new financial instruments with the explicit backing of the UAE government. At present there are no UAE federal bonds in issuance. The current economic malaise could be used as a catalyst to launch federal bonds by issuing a range of maturities. For example, the Federal government could use a form of "credit structure arbitrage" by issuing bonds and channeling the money to Dubai Inc entities.

Need to act proactively to restore economic normalcy