middle east supplement

CAPITAL MARKETS

Gulf streams of wealth

THE GULF IS NOW ACCEPTED AS A MAJOR FINANCIAL CENTRE, BUT HOW IS IT MOVING FROM SIMPLY HAVING LOTS OF MONEY TO BECOMING A GLOBAL CAPITAL FACILITATOR? **GRAHAM BUCK** FINDS OUT.

Executive summary

With a projected investment of $1.5 trillion in the Gulf over the next few years, overseas interest has never been higher. The younger generation, keen to exploit that potential, is looking to encourage the free and transparent flow of money through sophisticated financial instruments, upholding rule of law and relaxed laws on foreign investment. But it must also overcome potential problems of high inflation, repatriation of wealth and potential unrest.

If further evidence were needed of the increasing power and influence of the Middle East, it was provided by Gordon Brown's trip to Saudi Arabia last autumn to persuade its rulers to pump additional funds into the International Monetary Fund.

The personal visit to the region's leaders by the British prime minister, who was accompanied by 27 Western business leaders representing the banking, energy and construction sectors, came in the wake of Barclays announcement that it had secured £3.5bn of investment from Abu Dhabi's ruling family and a further £2.3bn from Qatar.

Middle Eastern wealth has also manifested itself in other, more exotic, scenarios – one of the more recent being the acquisition of Premier League team Manchester City by the Abu Dhabi United Group for Development and Investment.

"Who would have ever thought that some of the intricacies of a Sovereign Wealth Fund acquisition would be discussed at length on Sky Sports News?" comments Andrew Nicholls, a senior partner at Penrose Financial, the financial services and capital markets PR consultancy.

With Western banks increasingly looking to the region for growth opportunities as slowing growth in the US and Europe is succeeded by recession, Penrose believes the Middle East holds tremendous promise for companies able to offer genuine business opportunities to the region. As the firm notes, a staggering $1.5 trillion is projected for investment across the Gulf over the next few years.

However, in responding to the region's opportunities, Western banks have heeded the crucial role of Islamic finance, so are expanding their range of Sharia-compliant products and employing Islamic scholars to advise them. It is not yet clear whether this will be enough to win them business in the future, or if Arab clients will prefer to continue banking with local institutions.

Penrose's recently published report, *The Road of Opportunity: Evolving Capital Markets in the Middle East*, examines the region's financial landscape in detail and assesses its viability as a bona fide and sustainable financial centre.

There has been a plethora of material written about the Gulf and issues such as its ruling elite, its sovereign wealth funds (SWFs) and Sharia investment – hence the need for a guide that eliminates less relevant information and focuses on the opinions of Middle East experts and the main themes and trends likely to be important over the coming years.

The report begins by noting that the Gulf's elevation to a

THE RULERS OF THE MIDDLE EAST – MANY YOUNG AND WESTERN-EDUCATED – ARE MOVING FROM BEING WEALTH ACCUMULATORS TO CAPITAL FACILITATORS

major global financial centre is commonly accepted by companies around the globe, while Western banks and their “caravans of support services” have opened shop in the region.

But as its authors note, European and American commentators “swing between applauding and condemning the region’s rising economic power.” Growth has been accompanied by concerns over issues such as political stability and terrorism. And as the Sheikhs, their political elite and the all-powerful SWFs grow increasingly rich; questions have arisen over how sustainable the region will prove to be as a financial hub.

“Much has been written about the region’s viability as the next financial centre – with comments varying wildly between eulogies about its potential to pointed criticism of the lack of standardisation, rule of law and market sophistication,” says Nicholls. “The reality, as always, is somewhere between the two.

“While nobody doubts the sheer wealth of their economies, we all know that it takes much more than accumulated riches to create a financial centre. However, the rulers of the Middle East – many young and Western-educated – are moving from being wealth accumulators to capital facilitators.”

This means they realise that a financial centre is based on the free and transparent flow of money in and out, the report suggests. So there is an increasing readiness to embrace foreign ownership, relax restrictive laws on outsiders, uphold the rule of law, enhance transparency and introduce regulatory controls and sophisticated capital market instruments.

While it is probably too early to judge whether this goal of lasting financial centres can be achieved, the region’s massive infrastructure projects already act as vehicles for increased liquidity. Dubai is said to account for at least 25% of the world’s active cranes and has, with Abu Dhabi, ploughed billions into highways, major new cities, schools and hospitals. While these enormous projects continue, there will be demand for debt and structured finance to fund them. Project finance is well suited to Islamic financial instruments, which, as the report notes, need to be backed by physical assets.

The structuring of the deals is becoming more complex and, despite the vast local wealth, developers are seeking to both spread risk and raise their public profile by involving foreign partners. There is growing evidence to suggest that the Gulf “has the potential to be much more than a fleeting fascination for emerging market bankers”.

The report’s authors believe the huge investment in infrastructure represents rather more than mere ambition. Instead it is providing “the necessary physical framework around which the appropriate legal and regulatory system can be placed to create an efficient and sustainable financial hub” – or, in the words of one of the region’s major infrastructure firms, Abu Dhabi’s ALDAR Properties, they are “building a nation”.

Some countries in the region are also looking further afield and using existing relationships to participate in infrastructure projects in North America, China and elsewhere in Asia. An example was the $1.4bn deal signed in 2006 by Bahrain-based Islamic investment bank Gulf Finance House to fund two tourism projects in Morocco.

What are the likely future developments in the region?

The report concludes by singling out discernible trends:

GROWTH OF EQUITY AND DEBT MARKETS While Western economies suffer in the credit crunch, Middle Eastern markets will grow more significant as companies seek to raise funds from the region’s vast pools of liquidity.

CAREER OF CHOICE FOR FOREIGNERS Bankers and traders in the West increasingly see the region as a first choice in career advancement. It has gained credibility and is regarded by those in the investment community as a place to work and gain experience.

SPENDING There is a new awareness that the accumulated wealth of the Middle East should be spent. New areas are under review, with the investment plans of SWFs closely watched.

EMERGING PLANS Investors and the media are realising that the region has a plan and that the infrastructure projects are the lynchpin.

REGULATORY CHANGES The relaxation of foreign ownership rules will be watched, with Saudi Arabia of particular interest. Will it seek to extend its financial reach and its banks attempt to become the region’s leading financial institutions?

THE NEW GENERATION Younger, Western-educated Arabs who are setting up in business will influence the region’s development as a financial centre. Businesses are likely to continue restructuring and cross-border merger and acquisition deals are likely in addition to regional and local ones.

ATTRACTIVE LEVELS OF WEALTH The investment and business opportunities for financial service providers in the Gulf vary from one country to another, with the region’s wealth largely concentrated in the form of government funds and high net worth individuals.

Over the last decade, media attention has largely focused on Dubai and Abu Dhabi. Both countries have actively encouraged foreign participation, in a bid to diversify and lessen the reliance of their economies on oil.

The process has been accompanied by more social and economic freedoms than in neighbouring countries, helping to establish them as rewarding business venues for the foreign investor. By contrast, Saudi Arabia has proved to be possibly the most restrictive Gulf nation but is now slowly becoming more accommodating to foreign business. Riyadh is the most populous city with four million inhabitants and is regarded as the ideal centre for private banking and the biggest concentration of wealthy citizens.

The size of the region's available wealth is undoubtedly its biggest attraction. The steady increase up to last July's peak in the price of oil brought "incredible revenues" to the Gulf states, with each dollar rise in the price of crude bringing further billions to producing countries.

According to Penrose, of an estimated $3 trillion held by the Sovereign Wealth Funds, $2 trillion is located in the Gulf and the figure is set to reach $8 trillion-$10 trillion over the next decade. SWFs such as the Abu Dhabi Investment Authority increasingly seek advice on how to invest and fund new ventures both at home and abroad.

Around $1.5 trillion is slated for investment across the Gulf region over the next few years and billions of it will trickle down to outside investors, offering enormous business opportunities for Western companies.

Add to this around 400,000 high net worth individuals in the region who, according to a Capgemini and Merrill Lynch report, have a combined wealth of $1,700 trillion and offer an attractive market for institutions specialising in private wealth and asset management.

As these vast coffers of wealth are "closely entwined with the personal wealth of individual people and families", there are also ample opportunities for corporate and project financing.

The report notes that this wealth lies in the hands of the ruling elite and powerful indigenous merchant families. However, as the younger generations gain control, they are seeking to diversify their portfolios and this offers opportunities for those able to advise or manage the move towards new ventures, divestitures and initial public offerings.

THOSE EXPRESSING SCEPTICISM OVER WHETHER THE GULF CAN ESTABLISH ITSELF IN THE LONG TERM AS A CREDIBLE FINANCIAL CENTRE UNDERESTIMATE THE SOPHISTICATION OF A NEW GENERATION OF ARAB POLITICAL AND BUSINESS LEADERS

SOPHISTICATED YOUNGER GENERATION Those expressing scepticism over whether the Gulf can establish itself in the long term as a credible financial centre underestimate the sophistication of a new generation of Arab political and business leaders, suggests the report.

Many are Western-educated and are determined "to forge a new economic future by taking the best of the West and adapting it to their own countries and business sectors". They are fully aware of the need to overcome obstacles such as a lack of transparency in business dealings, high inflation levels and the need for the rule of law in certain areas.

This desire to modernise opens up business opportunities to firms offering financial, legal and communications advisory services, while Western banks have the chance to advise on and manage new investment and business strategies undertaken by the region's traditional businesses that want to restructure so they can better compete in global markets.

There is evidence in the growing number of initial public offerings, with the total in 2007 up 50% from 2006.

Barriers caused by uncertainty and perceived corruption are easing regulation steadily towards world-class standards, helped by professional advisers. However, one potential drawback noted by Penrose is that Gulf countries remain kingdoms, and lack the same checks and balances as democracies, meaning that any contract signed between businesses could be overturned without any legal consequences.

Press freedoms are also more limited than in the West, although there is growing acceptance that the media needs to be involved in the region's financial development, while SWFs and family-owned businesses recognise the need to engage with the West and improve ways of communicating their future investment strategies. The Abu Dhabi Investment Authority recently went as far as head-hunting a leading PR manager.

Demand for and trade in equities and Sukuk Islamic bonds is growing, while a relaxation on foreign ownership rules will help the Gulf establish itself as a financial hub. However, to ensure long-term success, it needs much greater critical mass. This would mean increasing its capital liquidity by introducing sophisticated financial instruments such as derivatives to facilitate the flow of funds. Large institutional investors such as hedge funds must also have a presence if its equity and debt markets are to develop to the same level as those in the West and Asia.

The absence of the two cornerstones of global capital markets, derivatives and debt, plus the issue of Sharia compliance, are largely responsible for the lack of capital market sophistication.

The region will need to develop these financial instruments and their markets in order to compete effectively, the report suggests. A tentative start has been made, with Western bankers calling for regulators to help develop the industry and the offshore Dubai International Financial Centre (DIFC) recently launching some regional derivative products.

Hedge funds are also curtailed by stringent rules against shorting stocks, although Saudi Arabia's Ajeej Capital and Dubai's Evolvence Capital have begun cultivating the beginnings of a local hedge fund industry with Western partners.

Of course, opportunities for Western banks and exchange operators to facilitate change by introducing new products and tools have become even more attractive due to the economic crisis in the world's other capital markets.

As a result, more bankers and traders are abandoning US and European markets in favour of the Middle East, although as Penrose points out, Islamic finance's lack of standardisation will slow the introduction of financial instruments and the growth of investment funds.

Other obstacles highlighted by the report are high levels of inflation – the emirates are likely to hit a rate of 13%-15% this year – and the local currencies' pegging with the dollar, which makes it difficult for foreign businesses and individuals to repatriate capital. High inflation raises the prospect of a crash in the property market, which would damage the area's investment reputation as property has proved one of the key high-returning assets for both local and overseas investors.

"The hype of the Dubai property market could very well be a bubble waiting to burst if greater control is not put in place," the report's authors comment.

ISLAMIC FINANCE IS ONE OF THE GREAT BOOM INDUSTRIES OF THE REGION. BUT IT IS A CLUB RUN BY THE ARABS ACCORDING TO THEIR OWN RULES AND WESTERNERS WILL STRUGGLE TO BREAK INTO IT – DESPITE THE EFFORTS OF SOME BANKS

Possibly less recognised is the impact of inflation, combined with poor working conditions and long hours, on the region's vast lower-paid migrant workforce. There is simmering unrest that could ignite something more serious.

The Gulf Co-operation Council (GCC) needs to address these problems by controlling mass speculation in the property sector and accelerating progress towards a single GCC currency pegged to a basket of currencies.

FOREIGN INVESTMENT OPPORTUNITIES The region's lack of transparency limits the opportunities for foreigners to invest directly in the Gulf. While the property and corporate sectors have begun to open up, there remains a host of ownership restrictions and doing business is made harder by the need to appoint local agents as mandatory partners and secure suitable financial licences.

Around 90% of businesses in the region are entirely or partly owned by the ruling "merchant" families, with much cross ownership of assets between families and rulers and no clear distinctions between banks and SWFs creating conflicts of interest.

But making the effort to overcome these obstacles is worthwhile. As Penrose notes, the Gulf region's enormous pools of liquidity are only partly tapped by conventional financial structures. Sharia-compliant banking services and products will open up large new sources of revenue. Assets invested according to Islamic guidelines have grown at around 20% annually worldwide and should reach the $2 trillion level by 2010, says Ernst & Young.

But as one analyst notes: "Islamic finance is one of the great boom industries of the region. But it is a club run by the Arabs according to their own rules and Westerners will struggle to break into it – despite the efforts of some banks."

And while the number of Islamic finance institutions is rising – with plans for the DIFC to establish a Sharia Centre, an Islamic hedge funds platform, an Islamic finance portal, a commodity murabah exchange and the creation of a judicial academy and research centre – the report questions whether demand will be sufficient to support all the potential new entrants.

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