Dubai: Decoding The Default

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The news that Dubai World, one of the stalwarts of the Dubai economy, is potentially defaulting on its debt is, quite simply, massive. It highlights the sheer scale of a financial crisis that Dubai has been doing its best to keep under wraps for more than a year. The situation is far from clear, but here is my assessment of what's happened so far, and what it means for Dubai.

What Do We Know For Sure?

The government's statement is, typically, sparse on details. What we do know is that Dubai World and Nakheel (one of Dubai World's subsidiaries) will ask for a 'standstill' on outstanding debts due over the next six months, extending maturities until 'at least' May 30, 2010. The debt that everyone is talking about is Nakheel's US$3.5bn sukuk, which was due to mature on December 14 (Dubai World's total debts are thought to run to US$60bn). The whole group is to undergo restructuring, as it attempts to get its finances in order.

Dubai also announced that it had sold US$5bn in bonds to two Abu Dhabi banks, National Bank of Abu Dhabi and Al-Hilal Bank. This is part of a US$20bn bond programme, earmarked for the Dubai Financial Support Fund (DFSF). The fund was set up to provide assistance to support distressed government-linked companies, but strangely, the government has stated that the US$5bn issue is not linked to the restructuring of Dubai World.

What Else Do We Need To Know?

Is this a default? In a word…probably. It is not yet clear whether maturities will be extended with or without the consent of investors. An involuntary restructuring would count as a technical default, which certainly appears to be on the cards for the Nakheel sukuk. To change the terms of the instrument, Nakheel would need the agreement of 75% of creditors at an extraordinary general meeting. But bond holders require 21 days notice for such a meeting, and the sukuk matures in just 18 days time…meaning that it will surely have to force the restructuring of terms.

How much does Dubai World owe, and when is it due? According to a statement issued by Nakheel in August, Dubai World had US$59.3bn in debt liabilities at the end of 2008, compared with assets of US$99.6bn. Deutsche Bank estimates that the group has US$4.3bn in debt maturing in December 2009, and a further US$4.9bn in the first quarter of 2010.

Why is the US$5bn bond issue not being used to repay Nakheel's debts? With Nakheel's US$3.5bn sukuk maturing in a matter of weeks, it is not clear why the government would raise US$5bn for the DFSF, yet not use it to pay off the emirate's most pressing debts. Dubai World controls some of Dubai's most high-profile companies, such as Nakheel and DP World, which have helped turn it into a real estate, financial and tourism hub, not to mention a global brand. Allowing Dubai World to default will do too much damage to Dubai's reputation for it not to be a priority.

This makes me think that Dubai World's debt problems simply run too deep for US$5bn from the

DFSF to be sufficient. While that would cover the cost of Nakheel’s sukuk, Dubai and all its government-related companies are estimated to have a total of US$13bn maturing in 2010, and a further US$19bn in 2011. If a restructuring has become inevitable, why not it get it over with sooner rather than later?

What Are The Implications?

Ratings Downgrade: DP World, Emaar Properties, Dubai Holding, DIFC Investments, DEWA and Jebel Ali Free Zone (JAFZ) have all had their ratings cut by Moody’s and S&P. This illustrates the key risk that a Dubai World default poses to the whole emirate – the massive uncertainty generated by the government’s decision not to bail out a state-owned company.

CDS Spreads Spike: Those creditworthiness concerns extend to sovereign debt. The CDS spread on Dubai government debt has shot through 500bps, and will probably keep rising. Spreads on sovereign debt in Abu Dhabi and throughout the Gulf are all heading higher.

Equity Downside: The restructuring announcement was cleverly timed to coincide with the Eid public holiday, so the full extent of the market’s reaction will not be known until next week. Suffice to say, I expect considerable downside moves in regional stocks when the markets re-open.

Abu Dhabi-Dubai Relations Under Scrutiny: This is maybe the most interesting aspect of it all. Basically, everyone thought that no matter how big its debts, Dubai would be OK, because Abu Dhabi would come to its rescue. This is why the markets became increasingly reassured that Nakheel would be able to repay its December debts, even though the firm was obviously in trouble. That accord appears to have broken down and the question is now whether Abu Dhabi will sit back and watch its extravagant neighbour get its comeuppance.

I can see why it would be tempting, but ultimately, it would be counterproductive. Abu Dhabi is hoping to emulate a lot of Dubai’s success in the coming years (without the tackiest bits or the colossal property crash of course), and Dubai’s collapse will do it no favours. The alternative scenario is that Abu Dhabi is punishing Dubai for its excesses, but will eventually step in to prevent an outright corporate crash. This could be a canny move, allowing it to pick up assets at bargain prices, and gain greater control over Dubai’s economic policy.