MIDDLE EAST
COMING OF AGE

After last year's record bond issuance in the Middle East, bankers are confident 2006 will see yet more growth. The region's first convertible bond and the emergence of a securitisation market are testament to its growing sophistication. **Hardeep Dhillon** reports

Dubai's Ports, Customs and Free Zone Corporation provided a fitting finale to a record-breaking year for *sukuk* (or Islamic bond) issuance in 2005 when in early December it opened the books on its blockbuster $3.5 billion convertible bond. The deal is the largest ever *sukuk* and the first Islamic convertible bond from the region; it brought the year's total bond volumes in the Middle East to $9.8 billion, more than doubling the $4.3 billion of issuance in 2004.

Lead-managed by Dubai Islamic Bank and Barclays Capital, the bond forms part of the $9.3 billion financing package for the acquisition of UK ports and ferries group P&O, the largest takeover-related transaction in the Middle East. The convertible nature of the offering allows bondholders a minimum allocation in the planned pre-2007 initial public offering of the PCFC Group, the holding company of Dubai ports unit DP World and Jebel Ali Free Zone.

Upon pricing in early January, total orders had surged to $11 billion, with strong interest coming from Islamic institutions, banks, asset managers, high-net-worth individuals and institutional investors in Europe and Asia.

Arshad Ismail, Dubai-based global head of *sukuk* at HSBC Amanah, the Islamic finance subsidiary of the global banking group, views the convertible *sukuk* as a defining moment for Islamic finance within the region. "From an industry development perspective we are pleased to see the deal launch as it shows that Islamic investors are maturing in tandem with the market," he says. "The deal has been very well received due to the feel-good factor vis-à-vis the equity markets in the region which greatly helped the marketing and distribution of the *sukuk*."

Ismail is optimistic that further issuance will follow as the transaction has alerted others to the fact that convertibles are a possible way of raising financing in a sharia-compliant manner. "This has caused a lot of interest among clients who have the right ingredients to launch a convertible *sukuk*," he adds.

Khalid Howladar, senior analyst covering Middle Eastern and Islamic structured finance at Moody's, believes the transaction is an astute and progressive move by the borrower, which is likely to have ready access to cheaper funding from local banks because it is a government-owned entity. "Dubai as a whole is thinking more longer term. Part of this strategy is creating a local securities market, where they can issue bonds and raise financing. This would allow for easier investment in the country and avoid a dependence on regional oil wealth for its development," he says.

Corporate reticence

Although the convertible is a good example of how far the market has progressed in the last five years, its success is masking the fact that non-financial corporate bond activity has been relatively scarce. Since Emirates Airlines launched the first corporate *sukuk* transaction in March 2004, the same borrower tapped the market again the following year, while the Dubai Free Zone Corp issued a $1 billion global deal in 2004 and Dubai Metals and Commodities Centre launched a gold-backed bond last year. Other issuance from the region is related to Qatar Liquefied Gas's expansion of its facilities at the Ras Laffan natural gas liquefaction plant.

Despite the scant volumes, bankers are nonetheless optimistic that more corporates will venture into the bond markets for funding this year. "As the region continues to grow, the need for funding will also increase and the *sukuk* is a robust and tested product that should do well in line with the development of the market," says Ismail at HSBC Amanah.

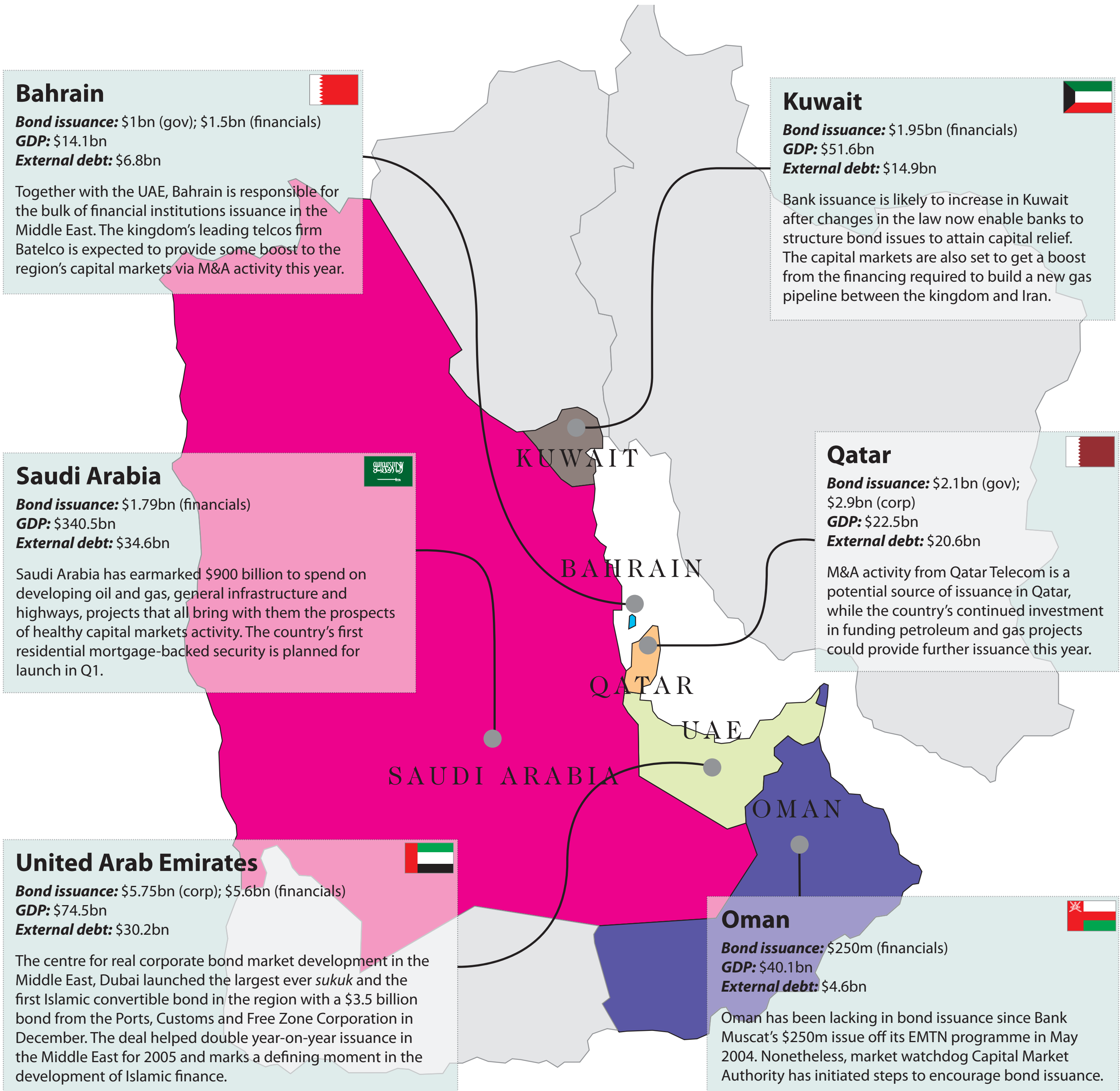
Gilles Franck, head of debt capital markets origination for emerging markets at BNP Paribas, also predicts a rise in corporate bond activity as more firms target the debt capital markets as an alternative to bank line financing. "There also is a greater awareness to be transparent and open up to the rating agencies, because by obtaining ratings corporates can widen the appeal of their transactions to the international capital markets," he says.

On a promising note for the market, many investment banks say they are pitching for or have deals in the pipeline. For instance, HSBC is currently working with Saudi Arabian corporates, while BNP Paribas is close to securing mandates within the Gulf Cooperation Council, an administrative body comprising many of the Gulf states.

In stark comparison, the financial institutions market exploded with issuance last year, with volumes skyrocketing to almost $8 billion from 14 transactions, compared with just over $2 billion in 2004. The majority of issuance has come from the United Arab Emirates (UAE) and Bahrain. The UAE has the biggest concentration of large banks and is expected to continue its dominance as lending continues rising in places such as Abu Dhabi and Dubai, says Jacques Tripon, head of corporate and institutional coverage for Middle East at BNP Paribas in Bahrain. Tripon also expects a rise in the issuance volumes from Saudi Arabian banks, despite the country's historically conservative approach.

Nicholas Hegarty, head of Middle East and North Africa investment banking at Barclays Capital in Dubai, firmly believes that issuance by Kuwaiti banks will increase with the changes to local law where deals can be structured in a manner to attain capital relief treatment. "If properly structured under this law, issuance, whether euro commercial paper or capital markets, is treated similarly to certificates of deposit rather than borrowing. Otherwise there will be limited issuance," he says.

The National Bank of Abu Dhabi (NBAD), Emirates Bank International and other banks that have set up European medium-term note (MTN) programmes are expected to issue



Bahrain

Bond issuance: $1bn (gov); $1.5bn (financials)
GDP: $14.1bn
External debt: $6.8bn

Together with the UAE, Bahrain is responsible for the bulk of financial institutions issuance in the Middle East. The kingdom's leading telcos firm Batelco is expected to provide some boost to the region's capital markets via M&A activity this year.

Kuwait

Bond issuance: $1.95bn (financials)
GDP: $51.6bn
External debt: $14.9bn

Bank issuance is likely to increase in Kuwait after changes in the law now enable banks to structure bond issues to attain capital relief. The capital markets are also set to get a boost from the financing required to build a new gas pipeline between the kingdom and Iran.

Saudi Arabia

Bond issuance: $1.79bn (financials)
GDP: $340.5bn
External debt: $34.6bn

Saudi Arabia has earmarked $900 billion to spend on developing oil and gas, general infrastructure and highways, projects that all bring with them the prospects of healthy capital markets activity. The country's first residential mortgage-backed security is planned for launch in Q1.

Qatar

Bond issuance: $2.1bn (gov); $2.9bn (corp)
GDP: $22.5bn
External debt: $20.6bn

M&A activity from Qatar Telecom is a potential source of issuance in Qatar, while the country's continued investment in funding petroleum and gas projects could provide further issuance this year.

United Arab Emirates

Bond issuance: $5.75bn (corp); $5.6bn (financials)
GDP: $74.5bn
External debt: $30.2bn

The centre for real corporate bond market development in the Middle East, Dubai launched the largest ever *sukuk* and the first Islamic convertible bond in the region with a $3.5 billion bond from the Ports, Customs and Free Zone Corporation in December. The deal helped double year-on-year issuance in the Middle East for 2005 and marks a defining moment in the development of Islamic finance.

Oman

Bond issuance: $250m (financials)
GDP: $40.1bn
External debt: $4.6bn

Oman has been lacking in bond issuance since Bank Muscat's $250m issue off its EMTN programme in May 2004. Nonetheless, market watchdog Capital Market Authority has initiated steps to encourage bond issuance.

bonds off their programmes this year. The largest MTN programme to date is NBAD's $5 billion programme arranged by BarCap. Hegarty feels that there will be more financial institution issuance this year, but at a slower rate and with a greater share coming from the smaller banks and in smaller size.

Deal liquidity is also on the rise. A year ago, Emirates Bank issued a five-year $750 million floating-rate note (FRN) which was the first deal to break the $500 million barrier. This record was broken six months later when Abu Dhabi Commercial Bank (ADCB) launched its $900 million five-year floater. As these transactions have hit the market, there has been substantial price compression, notes Hegarty. Emirates' first bond launched at 55bp over Libor in 2004, its second at 44bp, while the trend downwards has continued with ADCB pricing at 35bp and December's deal for NBAD which came tighter still at 30bp over Libor.

BNPP's Franck believes that issuance of FRNs will continue, although banks will aim for tenors longer than the current standard of five-year maturities. In addition, some may diversify away from the dollar – the natural currency for the Middle East – and find an alternative in the euro-denominated market. "Typically 40–55% of outstanding dollar floaters have been placed in Europe, so there is already a strong investor and demand base. Even at roadshows, some investors have been questioning why there is no euro issuance and only dollar bonds. With this interest, you will see banks tap the euro market as a diversification play as long as the cost is not prohibitive," he predicts.

Banks are also looking more closely at their balance sheets and at active management of their capital base, which Franck sees as a boost to issuance of lower tier 2 and possibly even hybrid capital transactions this year. "Institutions are realising that you do not

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A slow start for securitisation

A booming consumer lending sector and a vast and growing mortgage market would normally result in a healthy securitisation market. But this has not been the case in the Middle East.

There has only been one mortgage-backed transaction to come out of the asset-rich region, from Emirates National Securitisation Corporation (Ensec – *see box*). Nonetheless, bankers are optimistic that the market could take off this year.

Ensec has certainly taken the lead in attempting to establish a primary real-estate market and a standardised secondary mortgage market. "Ensec is looking to become the Fannie Mae of the Middle East. The intent behind the transaction was to establish a mortgage-backed securitisation market in the Middle East with a strategic aim to target US distribution and thus tap a new investor base," says Nicholas Hegarty, head of Middle East and North Africa investment banking at Barclays Capital.

Khalid Howladar, senior analyst covering Middle Eastern and Islamic structured finance at Moody's, believes that the government is so asset-rich that it could easily create its own universe of liquid securities that could form critical mass for the market going forward. "As with many things in Dubai, the 'build it and they will come' approach is in evidence," he says. "They are trying to develop a sophisticated secondary mortgage market from scratch by sponsoring issuance of such securities."

Some question marks remain as to whether the Ensec transaction can be characterised as a 'true' securitisation. "There was no real transfer of risk for the first deal due to the cash collateralisation, but it served the important purpose of putting Dubai on the map for local asset-backed securities. In future, as investors become more comfortable, it's likely that such 'features' will be withdrawn and we'll see true securitisations with real risk transfer," says Howladar.

Tamara Box, partner in the capital markets practice at law firm Lovells in London, is another that does not perceive the deal as a pure securitisation, stating that the complex nature of the transaction necessitated a variety of structuring mechanisms. "It is not necessarily the most efficient of transactions and the collateralisation is significant," she says. "But it is a move in the right direction."

She is cautiously optimistic about the development of the market. "The key is how the market is going to progress over time from the straightforward structures to the more complex products because that is what the investor base within the Islamic finance marketplace is demanding. And many prominent issues remain: what kind of liquidity will there be in this market and to what extent is the market as deep as we predict?" she says.

Box adds that Lovells is in the process of completing a residential mortgage-backed security (RMBS) issue in Saudi Arabia "We are targeting early the first quarter of 2006 [for launch]," she says. "It is likely to be a private transaction, not a fully listed public deal. It will be fairly small, but the transaction is for a big player in the market that is dipping its toe into have to solely rely on capital increases but can access the debt market in order to bolster capital ratios," he says.

In addition, the strong distribution of these deals outside the region – the ADCB deal was placed 75% into Europe and Asia – is allowing banks to diversify their investor base. "This has mitigated that concern of cannibalising existing bank lines and distributing into a captive investor base. Some banks have hit sector constraints or one-client lending limits, so they need to find mitigants to these problems, even though they are well capitalised," says BarCap's Hegarty.

Merger and acquisition activity, particularly in the financials, telecoms and media sectors, is also set to pump more bonds into the market, say bankers. BNPP's Tripon forecasts M&A in the telecoms sector due to saturation in the local markets and forecasts a rise in activity from Kuwait, Etisalat (Abu Dhabi), Qatar Telecom or Batelco, Bahrain's leading telecom operator.

The banking sector has already seen acquisition-related issuance in the last year and bankers feel that more will follow. The 2005 deals from Ahli United Bank and Commercial Bank of Kuwait were launched to strengthen the banks' capital ratios after increasing their respective stakes in Bank of Kuwait and Middle East, and Bank of Bahrain and Kuwait.

BNPP's Tripon forecasts more concentration in the banking sector and more M&A activity as the banks look to expand and dominate on a regional basis. The National Bank of Kuwait and Ahli United Bank have made acquisitions in the past year, and Tripon predicts that some of the larger players in the UAE and Saudi will follow suit.

Overall though, bigger bulk issuance will come from project and infrastructure finance. The significant size of the investment needs over the next five to 10 years for the projects currently on the table are hitting the multi-billion mark. For instance in Dubai, the Jebel Ali airport development is estimated at $30 billion, in addition to ambitious developments such as offshore residential developments The Palm and The World. Saudi Arabia has earmarked $900 billion to spend on developing oil and gas, general infrastructure and highways. Investment in Qatar will be related to funding petroleum and gas projects. And Iran and Kuwait are building a gas pipeline between the countries.

A direct consequence of these projects is that financing will be required in the capital markets. Though initial funding will be taken out in the syndicated loan market, there will be a need at some stage to term this out with bond issuance, which bodes well for the development of the local debt markets.

the water. At this stage, people are not prepared to take big portfolios into the market but are rather testing the market." Lovells is looking at other possibilities within the UAE and Kuwait in consumer assets and commercial property.

The potential and drivers for the market are evident: the region is rich in assets, such as property, fast-growing consumer finance, credit cards and mortgages – though this has not translated into steady deal flow. Nonetheless, seeds of change are sprouting in Saudi Arabia and Kuwait, where the central banks are working on introducing securitisation legislation, which will help the development of the asset class, says Jacques Tripon, head of corporate and institutional coverage for Middle East at BNP Paribas.

Over the course of the last 12 months, Moody's has seen volumes of inquiry in securitisation shoot up in the region both from investment banks chasing mandates in the region and institutions looking to tap the market. Arshad Ismail, global head of *sukuk* at HSBC Amanah, says his bank has been in close dialogue with clients who have expressed interest in launching securitisation transactions. He believes HSBC will arrange at least two deals this year. "The real-estate market will be a natural choice for deals and though not a lot of investors are familiar with securitisation transactions, it fits neatly into an Islamic structure. It is just a matter of educating the investor community and finding clients who have suitable assets that you can package into sharia-compliant structures," he says.

What is Ensec?

Dubai Islamic Bank, Istithmar and Island Capital Group have created Emirates National Securitisation Corporation (Ensec) to facilitate the development of a secondary mortgage system in Dubai, similar to Fannie Mae and Freddie Mac in the US. Ensec will work with government entities and local banks in Dubai to securitise pools of residential and commercial loans on real estate in Dubai. This makes the Ensec deal the only true securitisation conduit in the region.

Ensec 2005-R1 is the first ever triple-A rated, asset-backed securitisation to come out of the United Arab Emirates and is the first in a series of residential and commercial securitisations. Its structure, including the provision of cash collateral, is effectively analogous to the 100% US government guarantee that secured early US issues of Fannie Mae.

Barclays Capital acted as sole bookrunner, with Bear Stearns, Nomura and Citigroup serving as placement agents. The $350 million of floating-rate bonds were marketed exclusively to US and European institutions primarily to maximise Dubai's exposure to the global capital markets. Demand for the issue topped $4 billion. The bonds are backed by mortgages deriving from The Palm at Jumeirah, a man-made island constructed off the coast of Dubai consisting of 4,600 residences and 22 hotels.